

# FIRST 5 FINANCIAL MANAGEMENT GUIDE



A cooperative project of The California Children and Families Commission and  
The First 5 Association

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## GLOSSARY

## **PREFACE**

This First 5 Financial Management Guide is a major advance for First 5 management statewide. It provides a standard approach to financial management that can be adopted by commissions at their discretion and also leaves sufficient flexibility, where flexibility is possible, for commissions to manage their financial resources consistent with circumstances specific to each commission—whether small or large, independent, or county-affiliated.

The Guide is a product of the California First 5 Association's and the State Commission's joint technical assistance effort. It is a direct result of a financial management assessment of First 5 commissions conducted by the Government Finance Officers Association of the United States and Canada in 2004 on behalf of the First 5 Association and the State Commission. Several other action items in addition to preparation of the Guide resulted from the assessment, including plans for increased peer-to-peer cooperation on financial management, training of financial management staff, and an ongoing financial management technical assistance effort to be coordinated by the association. These activities are being planned and implemented concurrently with production of the Guide.

Although it will be used primarily by First 5 financial managers and Executive Directors, because it is in electronic format on the First 5 Association's Web site, the Guide also is accessible to all Proposition 10 stakeholders to inform and educate them on appropriate policies and procedures for managing financial resources in commissions.

The electronic format also enables readers to go directly to links containing definitions, model documents, and additional resources. The Guide will be a “living” document. As additional best practices are developed, as new legislation relating to Proposition 10 is enacted and as other changes occur in the First 5 environment, the Guide can easily be updated.

Many individuals and commissions participated in this effort over the past several months. Members of the First 5 Fiscal Technical Assistance Leadership Committee met several times for many hours through the process, providing guidance, reviewing drafts, and supplying examples from their own commissions' financial management policies and procedures. Staff from the State Commission as well as from commissions across the state willingly contributed advice and examples that helped to assure that the Guide would not only reflect best financial practices in government but that it would be customized to suit the unique First 5 environment. The Government Finance Officers Association's team identified best practices in all the areas of financial management addressed in the Guide, prepared and revised drafts, and provided updates on the project at First 5 Association meetings.

We would like to thank all who participated in and supported this effort.

Sincerely,

Joe Munso  
*Interim Executive Director*  
California Children and  
Families Commission

Mike Ruane  
*President*  
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## **INTRODUCTION**

The purpose of this First 5 Financial Management Guide is to help commissions establish and refine their financial management policies and practices. The Guide contains best practices, standard practices, and in some instances, emerging practices in governmental finance. The policies and procedures included in the Guide have been tailored where possible to the specific needs and environment of First 5 commissions.

The Association and the State Commission contracted with the Government Finance Officers Association of the United States and Canada (GFOA) to prepare the Guide and created the First 5 Fiscal Technical Assistance Leadership Committee, comprising local financial managers and executive directors as well as State Commission staff, to guide the effort. Members of the group are listed below.

This guidance is provided as a resource to assist commissions in the development of their financial policies and practices and is not intended to be mandatory. To the greatest extent possible, the Guide relies on practices that are required by Proposition 10 enabling legislation or other sections of the state statutes governing First 5 commissions, and those that have been established by nationally recognized sources such as the Governmental Accounting Standards Board (GASB) and the GFOA. The Guide also builds on work previously commissioned by the First 5 Association, specifically in the areas of long-term financial planning, fund balance reporting, and accounting and financial reporting.

The Guide has been developed in response to the First 5 Association's identification of priority areas, based in part on an assessment of commission financial management conducted by the GFOA in 2004. The areas of focus include: budgeting, accounting and financial reporting, investment management, contracting, and select items such as administrative costs definition and limits. Each chapter covers one topic and includes recommended policy statements, model procedures, references to model documents, examples from commissions and additional resources. Additional chapters may be developed in the future. A specific focus throughout the process was to ensure that the Guide contain financial management policies and practices applicable to all commissions, whether small or large, independent or county-affiliated.

The committee and the GFOA team met eight times during development of the Guide to develop concepts and review and revise chapters. Committee members contributed significantly to the Guide by providing numerous improvements to the text and examples of First 5 best practices from their local commission operations.

The final document is presented in electronic format so that readers can quickly access specific sections and click on links to definitions, model documents, examples, and other resources. The Guide is a living document—it will be updated as required to reflect changes in the First 5 environment as well as in national best practices and financial management standards.

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## **CHAPTER 1: CONTRACTING**

### **1.1. INTRODUCTION**

The purpose of this section is to set forth recommended contracting and contract administration guidelines for First 5 commissions. These guidelines are based on best practices in public procurement and reflect the flexibility necessary to accommodate independent commissions and county-agency commissions in small and large counties.

Best practice in governmental contracting requires a selection process that is based on the open and fair identification and selection of vendors qualified to render a particular service, taking into consideration both technical qualifications and price. Consequently, service contracting rules usually permit the use of a request for proposals (RFP) process rather than mandating selection of the lowest complying bidder. However, best practice also recognizes that conducting an RFP process is not the only way to assure open and fair selection of qualified service providers. Other procedures are available that can meet the best-practice requirements of fairness, openness, and thorough documentation.

### **1.2. POLICY STATEMENT**

The distribution of Proposition 10 funds shall be conducted economically and expeditiously, under fair, open, and well-documented procedures, and in accordance with best procurement practices. Commissions should issue a contract when entering into agreements with providers for the use of Proposition 10 funds. Contracts should link the performance of providers to the objectives of the strategic plan through the use of indicators of performance (outputs and/or outcomes), interagency linkages, or progress on sustainability to be achieved. Commissions should take the necessary measures to ensure that providers comply with the terms of their contracts and deliver desired results for the target clientele.

The procedures in this section are written for local commissions. Where county ordinance or policy is inconsistent with these procedures, the ordinance or policy shall necessarily take precedence; however, if the county government agrees, commissions may be able to use the procedures in this section by waiver or formal amendment of county ordinance or policy.

### **1.3. PROCEDURES**

#### **1.3.1. Provider Selection**

The First 5 Association of California has identified a set of principles to help commissions award Proposition 10 funds to providers that are best qualified to support the purposes outlined in the strategic plan. Commissions should keep these principles in mind as they apply the procedures for selecting providers outlined in this section. The principles are:

1. Create strategic impact. Fund programs and activities that:
  - Support the goals in your strategic plan
  - Show evidence of effectiveness

- Need Proposition 10 funding in order to meet your goals
2. Promote inclusion. Fund programs and activities that:
    - Are responsive to the diverse needs of members of your community
    - Have been shaped by community input
  3. Move toward service integration. Fund programs and activities that:
    - Reduce the fragmentation of existing services
    - Make services more accessible and comprehensive
    - Support shared decision making and shared resources among partners who need others to succeed
  4. Build on strengths/build capacity. Fund programs and activities that:
    - Take advantage of organizational and neighborhood assets
    - Help participants to further develop their capacities

There are two ways to select providers: (1) Conducting a request for proposals process and (2) Selecting a “sole source” provider through an alternate process that is publicly disclosed.

### 1.3.2. Request for Proposals (RFP)

Commissions should use a formal process (such as the one outlined below) for awarding Proposition 10 funds to qualified providers in amounts exceeding a pre-determined dollar threshold. This threshold shall be determined by each commission based on historical procurement patterns and level of control preferences.

For projects that fall below this threshold, the commission may choose to use an informal process for allocating funds. In this case, the commission should solicit at least three offers in writing. If it is not possible to obtain three offers, the reasons should be documented in writing, by fax or by phone. If the solicitation is by phone, a written record must be created. The commission should maintain adequate records relating to all informal procurements, which shall be subject to post-audit review.

Staff will develop the RFP, with general policy direction from the commission as needed.

All RFPs should be brought to the executive director and/or the commission for approval to release.

All RFPs should be sent to inquiring and relevant parties, posted on the commission Web site, and advertised in newspapers of general circulation in the county.

The RFP should include the following elements (see model RFP document):

1. A statement of work that contains:
  - Child outcomes and/or interagency linkages to be achieved and the performance measures to be used to evaluate progress toward those outcomes.
  - A description of the system that will be used to evaluate the provider’s performance.
  - Practical and policy information, technological requirements or specifica-

tions, and legal limitations, if any.

- Specific questions to be answered or issues to be addressed.
- Performance timelines or completion dates.
- Required quality control standards to be met, if applicable.
- The format and number of copies of the completed progress reports and final report, if applicable.
- The extent and nature of the assistance and cooperation from the commission that will be available to the bidder.

2. Selection process, including:

- Standards the commission will use in evaluating proposals.
- Information on how the commission will select the winning proposal.

3. Time schedules, including:

- Date to submit questions or seek clarification of the RFP.
- Date of bidder's conference, if applicable.
- Date on which the proposals must be submitted.
- Timetable the commission will follow in reviewing and evaluating proposals.
- Date of cost proposal meeting.
- Date of award.
- Anticipated contract term, including commencement and completion dates.

4. Notice of payment terms or restrictions, including:

- Whether and to what extent cash advances will be allowed.
- Whether and to what extent progress payments will be allowed.
- Penalties for late or inadequate performance.
- Known or estimated budgetary limitations on the contract price, if applicable.

5. Requirements that prospective bidders must address or include in their proposal, such as the following:

- Proof that the bidder, if a corporation, is in good standing and qualified to conduct business in California.
- For bidders that are nonprofit organizations, proof of nonprofit status.
- Copies of current business licenses, professional certifications, or other credentials.
- Proof of financial solvency or stability, as deemed applicable.
- A list of current or former references for which the bidder has performed similar work.
- A brief list of similar types of contracts that were successfully concluded, with a sample of such work.
- A description of the lead personnel and anticipated supporting personnel to be employed during performance and their qualifications to perform the work.
- Identification of a project coordinator.
- Resumes for each major contract participant who will exercise a major policy, administrative, or consultative role in carrying out the services.
- An overall description of techniques, approaches, and methods to be used in performing the services.
- If subcontractors are contemplated, identification of those persons or firms, the portions and monetary percentages of the work to be done by the subcontractors, how they were selected and why, resumes of each major sub-

contract participant, and a description of how subcontracted work will be controlled, monitored, and evaluated.

- The total cost of the project, with a detailed breakdown showing how the costs were determined, and the desired method of payment.
- Identification of services provided on a flat fee, lump sum, or unit rate basis.

Before releasing the RFP proposals, the commission should develop and finalize an evaluation plan.

The commission should evaluate proposals using some variation of the following process:

1. A proposal review committee is formed of persons with knowledge or expertise in the field.
2. All reviewers are asked to sign a standard conflict of interest form and to remove themselves from the committee if a conflict is presented.
3. Staff develops a scoring matrix for each proposal that will provide consistency and guidance for rating responses (see model evaluation plan).
4. The executive director or other designated agent makes a final recommendation to the commission based on the results of the scoring matrix.
5. Final approval of the award rests with the commission.

For smaller commissions, a proposal review committee may not be feasible. If it is not, then the person or persons conducting the review should adhere to this process.

In developing criteria for evaluating proposals, the commission should use the principles outlined in Guidance to County Commissions on Allocating California Children and Family Act (Proposition 10) Funding:

- Does the program or activity fulfill the purposes of your strategic plan? Does it respond to the known needs of your community's Proposition 10 population, as established in your community assessment? Is it necessary to achieve the results you've identified in your strategic plan, especially for ethnic groups, language minorities, and special needs children and families?
- What is your evidence that the program is or will be effective in meeting your goals? Is the program based on current research? Has it been evaluated? If the program would be new to your community, has it been implemented in a community similar to yours, so that it's reasonable to assume that similar outcomes could be achieved in your setting?
- Does the program or activity target the particular group or groups you've identified as needing it the most?
- Does the program or activity improve the balance of services and activities in your community between prevention/asset development and intervention?

- If the program involves direct service, is it developmentally appropriate? Does it provide support for growth, or intervention in the case of difficulty, at the earliest and/or most appropriate time?
- Is Proposition 10 funding required in order for this program to be effective toward your goals?
- Is the program sensitive to and respectful of different cultural beliefs and practices within your community?
- Would the program effectively serve special needs children and families?
- Have service recipients been involved in developing the program, its processes or products?
- Would inclusion of this program or activity in your Proposition 10 funding plan make the plan as a whole more responsive to diverse sectors of your community?
- Does the program fill a gap in existing resources within the county, or supplement and strengthen existing resources, as opposed to creating duplication or fragmentation?
- Does the program or activity support shared accountability among those responsible for the well being of children in your community?
- Will the program or activity help to integrate existing services for young children in your community at the neighborhood level, making them more comprehensive and accessible?
- Does the program or activity support service providers and staffs to function in a more flexible and multidisciplinary way?
- Are there ways to maximize the advantage of Proposition 10 funding for this program or activity through blended funding or leverage of other funds?
- Does the program or activity identify and enhance existing community strengths?
- Will the program or activity help to build capacity in an underserved area by bringing in new providers or by working with providers already there to increase their effectiveness?

### 1.3.3. Sole Source Procurement

Sole source procurement should only be used when competitive procurement procedures are deemed infeasible for at least one of the following reasons:

- There is only one viable provider of the required service in the community.
- After solicitation of a number of sources, competition is determined to be inadequate.

- All local providers of a particular service will receive funding.
- The commission is contemplating an effort that has not previously been done in the community and is therefore unable to either develop an RFP with sufficient specificity or to identify potential providers.

Whenever sole source procurement is used, the rationale must be fully justified in writing and approved by the commission or its designated agent (e.g., executive director) before a contract is signed. The documentation justifying a sole source procurement should include the following:

- The effort made to solicit competitive bids or proposals, if any.
- A summary outlining the reason for the sole source, based on the allowable exceptions set forth above.
- Cost information in sufficient detail to support and justify the cost of the contract as reasonable and fair.
- Cost information for similar services and differences that should be noted and explained.
- Special factors affecting the cost under the contract.
- An explanation of why the commission believes the cost is appropriate.

*Intent to Negotiate.* This is a form of sole-source procurement that has been used successfully by First 5 commissions to fulfill the unique mission of the Proposition 10 initiative. Commissions may select providers by engaging in community-based planning efforts in which stakeholders come together for the purpose of identifying specific needs and the providers best able to meet those needs. These meetings may result in an “intent to negotiate” with potential service providers. If this method of selecting sole-source providers is used, the dates and times of these meetings should be advertised well in advance and all potential providers must be invited to participate. Funds should not be awarded during these meetings. The natural bias toward competitive procurement should apply; any exceptions should adhere to the guidelines outlined in this procedure.

*Request for Information (RFI).* For cases in which a new effort is initiated and no apparent service providers exist, or where a commission is not able to prepare an RFP, commissions may elect to issue an RFI. The RFI should contain a description of the need to be met and/or results to be achieved and invite responders to provide approaches to meeting needs or achieving results. The RFI may or may not request a price; if a price is not included, there are two methods for proceeding:

1. Once a recommended approach is selected, the commission may elect to proceed to negotiate a fair price with the selected provider. In this case, the process for sole source contracting described above should be used. If more than one provider has submitted substantially the same approach, parallel negotiations on price and other conditions may be used.

2. Once a recommended approach is selected, the commission may elect to proceed with an RFP process to select a provider. However, moving to an RFP process in this case may be problematic. Providers that have expended resources to develop a new approach are unlikely to be willing to provide this service if they know that their approach is to be used to select other providers. If a commission decides to use this two-stage process, providing a fee to the selected approach is advisable.

#### 1.3.4. Notification and Appeals

Once a decision has been made, the commission should notify all bidders in writing of the intent to award the contract.

As a courtesy, the notice should offer unsuccessful bidders the opportunity for a de-briefing after the contract has been awarded. In a de-briefing, commission officials should explain to the unsuccessful bidder the rationale for the decision. The de-briefing process can help minimize appeals and may lead to higher quality proposals in the future.

The notice should also outline the appeals procedure. The following is a recommended appeals procedure:

1. The appeal must be filed within a timeframe to be determined by each commission based on local needs.
2. The appeal must be in writing and sent by certified or registered mail or delivered personally. If the appeal is hand-delivered, a receipt must be requested.
3. The appeal shall include the name, address, telephone, and facsimile numbers of the party appealing or its representative.
4. The title of the RFP under which the appeal is submitted shall be included.
5. A detailed description of the specific legal and factual grounds of appeal and any supporting documentation shall be included. The appeals process may only be used to contest a procedural aspect of the review process (i.e., fair and consistent application of rules and standards), not the merits of the proposal.
6. The specific ruling or relief requested must be stated.

The commission or its designee (e.g., the executive director), at its discretion, may make a decision regarding the appeal without requesting further documents. Therefore, the initial appeal must include all grounds for the appeal and all evidence available at the time the appeal is submitted. If the protestor later raises new grounds or evidence that was not included in the initial protest but that could have been raised at that time, the new information will not be considered.

Upon receipt of a timely and proper appeal, the commission or its designee will investigate the appeal and provide a written response to the bidder within a reasonable time. If a response cannot be provided within a reasonable time, the vendor will be notified.

If the appeal is upheld, the commission or its designee shall consider all circumstances surrounding the procurement in its decision for a fair and reasonable remedy. The commission or its designee may elect to take any of the following actions:

- Refer the results of the appeal back to the proposal review committee and direct it to review its decision and then make a selection.
- Conduct interviews with each of the bidders and then make a selection.
- Re-open the RFP process.

Providers whose contracts are ending and who apply for and are denied continued funding should use the same process for appealing those decisions.

### 1.3.5. Contracts

Every contract document should identify the contracting parties and include four major elements: (1) scope of work, (2) contract term, (3) contractor payment, and (4) terms and conditions. Each element must be clearly defined in every contract so that the commission's needs are met and the commission and the contractor understand their performance obligations. (See model contract document.)

#### 1.3.5.1. Scope of Work

The contract should:

- Clearly define performance, outcomes, and/or interagency linkages to be achieved.
- Identify the performance measures to be used to evaluate contract compliance.
- Identify project milestones as well as any service deliverables or tasks for which the contractor is responsible.
- Address the possible conditions that may arise during performance of the contract that would trigger additions or deletions to the scope of work, schedule, or consideration.
- Additional descriptive information may be attached to the contract as an exhibit to help define the scope of work. This information often includes outcome measures and reporting guidelines.

#### 1.3.5.2. Contract Term

Time is usually a critical element in every contract. The schedule of when work shall be started and completed should be included in the contract. If applicable, interim dates for the completion of specific portions of the contract should also be stated.

### **1.3.5.3. Contractor Payment**

The cost to the commission (or the price it will pay the contractor) for services under a contract should be clearly stated:

- The cost may be expressed as a lump sum (one-time payment), firm fixed price, unit price, labor rate, or other specific cost basis.
- If the commission is contracting for labor, a schedule listing the hourly, daily, weekly, or monthly cost for each person or job classification should be incorporated into the contract. This includes firm fixed price or lump sum contracts, where the schedule may be used as the basis for establishing the cost of additional work authorized under the contract.
- Each party's responsibility for costs such as shipping, sales tax, permits, licenses, bonds, etc.
- With regard to payment, the contract should define how frequently the contractor may submit invoices and what the terms of payment will be.
- If the commission requires contractors to use special forms or formats in submitting invoices, those conditions should be stated in the contract. The commission may wish to consider developing a program handbook (see model program handbook) to help providers comply with the reporting requirements in the contract.
- The contract should define the conditions under which the commission may withhold payment, either as retention or in the event of a dispute with the contractor.
- The contract should clearly state when payment or partial payment is due and whether or not payment is tied to completion or acceptance of tasks or deliverables.

### **1.3.5.4. Terms and Conditions**

Contract terms and conditions can be somewhat flexible to suit the needs of the commission and the specific contract circumstances. It is the responsibility of authorized commission staff to ensure that contract terms and conditions are appropriate to the type of contract being awarded. Examples of contract terms and conditions include, but are not limited to:

- Contract schedule, specifications, and quantities
- Delivery or completion dates
- Contract type
- Independent contractor
- Payment terms and frequency
- Withholding of payments
- Availability of funds
- Supplantation
- Assignments and subcontracts
- Warranty

- Allowable vs. unallowable costs
- Requirements for bonds or letters of credit
- Program monitoring and evaluation
- Labor documentation
- Financial requirements
- Insurance requirements
- Indemnification
- Nondiscrimination
- Child abuse prevention and reporting
- Smoke free premises
- Liquidated damages
- Termination clauses
- Contract changes clause
- Audit rights
- Disputes and dispute resolution
- Contract suspension
- Remedies
- Confidentiality
- Ownership of deliverables
- Notice

Service providers should maintain and show proof of adequate insurance coverage before beginning work on any contract with the commission. Certificates of insurance should be received from the contractor or be verified as current and on file with the commission prior to the beginning of any work, unless the executive director has approved a request for extension. Service providers should maintain insurance coverage that is appropriate to their business operations and the nature of the work. The commission should determine what kinds and levels of insurance are required. In general, insurance coverage should include:

- Workers compensation and employer's liability
- General liability
- Commercial automobile liability
- Personal automobile liability
- Professional liability

Contracts should be executed by signature of the executive director or other designated agent of the commission. In addition, the provider should provide all applicable insurance and bonding documentation prior to beginning work. The commission's files should include an original, fully executed copy of every contract it enters into.

### **1.3.6. Performance Monitoring and Reporting**

The commission should develop a system to ensure that the performance of providers meets the standards identified in the service contract and contributes to the achievement of outcomes identified in the strategic plan. This includes developing processes for collecting outcome data from providers and for reporting on such data to the communities they serve, the State Commission, and other stakeholders.

Traditionally, public sector compliance efforts have involved detecting and punish-

ing violators in order to deter future instances of noncompliance. Such efforts assume the worst about people and assume that they must be forced into compliance. This can be effective, but it is also very expensive. Many public sector leaders now recognize that there are less expensive and more effective options. These options motivate through pride, peer pressure, rewards and recognition—not fear. Such methods are characterized by such things as educating compliers, streamlining inspection processes, and providing resources to make it easier to comply. The commission should strive to win voluntary compliance from service providers rather than using heavy-handed enforcement approaches.

The methods to be used in monitoring a contract should be outlined in the contract itself and should include a combination of progress reports and site visits, depending on the provider's risk profile.

To ensure that limited resources are being used in the most efficient manner, the commission should adopt a risk-based approach to monitoring and reporting. The essence of the risk-based approach is that some providers present less risk than others and thus warrant less scrutiny by the commission. Below are procedures for a basic risk-based monitoring system:

1. Develop reporting requirements that will apply to all providers regardless of the risk assessment. These requirements should contain information that is essential to the commission's own information needs and no more. Additional reporting requirements will be placed on providers based on their risk profile.
2. Develop a standard scoring matrix for assessing provider risk. Criteria might include such things as the experience of the agency in successfully completing similar projects, number of years in operation, expertise of staff, financial solvency, etc.
3. Develop reporting requirements to correspond to various levels of risk (low, medium, or high, for example). Reporting requirements should increase as the level of risk increases. High-risk agencies should be subject to regular site visits in addition to meeting established reporting requirements.
4. Use the scoring matrix above to assess the agency and assign a level of risk (low, medium, or high).
5. Communicate reporting requirements to the agency and provide assistance as needed.

The reporting system should provide the essential information needed—no more, no less—to determine whether Proposition 10 funds are being used appropriately and whether the provider is producing the results specified in the contract. Reporting requirements may vary from provider to provider, depending on the level of risk involved. The type, format, frequency, and substance of reports will depend on the needs and circumstances of each commission.

Interim progress reports should include the following basic information:

- Work progress to date, including progress toward measurable results
- Comparison of work progress to date with contract schedule and measures

- Expenditures to date
- Comparison of expenditures to date with contract budget
- Level of service provided
- Issues or barriers encountered and how they are being addressed
- Number of clients served

Progress reports should be reviewed by program and financial staff to ensure that both program and fiscal progress is on target.

In addition, the commission should conduct on-site fiscal compliance audits of service providers. The purpose of such audits is to verify that progress reports are accurate and that proper documentation exists to support provider claims. The following are recommended procedures for conducting fiscal compliance audits:

1. Include a provision in the contract that gives the commission the right to enter the provider's premises and inspect any records pertaining to the services performed under the agreement.
2. Notify all providers at the time the contract is awarded that the commission will conduct random fiscal compliance audits.
3. Decide whether commission staff will perform the audits or whether the commission will use county resources or outside auditors.
4. Develop a method for selecting the sample of providers to audit. This method should correspond to the risk-based monitoring system described above; more high-risk providers should be audited than medium-risk providers, and more medium-risk providers should be audited than low-risk providers. At least one provider from each category should be subject to audit, so that all providers have a chance of being audited.
5. Determine the specific compliance items to be evaluated and develop a tool to be used in performing the evaluation (see model fiscal compliance audit form).
6. Schedule the audit and submit any requests for information or for interviews with provider staff.
7. Conduct the audit. Audits may include but should not be limited to the following:
  - Note location of financial records and verify that these documents are secure
  - Verify that copies of required licenses, certificates, and insurance policies are on file, as well as approved contracts/budgets for sub-contractors
  - Verify completion of financial audit; not, any audit findings and whether recommended corrective action has been taken.
  - Verify that there is adequate separation of duties for authorizing, processing, recording, and reviewing contract transactions.
  - Test a sample of disbursements to ensure that they are supported by adequate documentation.
  - Test a sample of disbursements to verify that they are allowable under the contract.
  - Verify that actual disbursements match claims/reports submitted to the com-

mission.

- Verify that advance payments were expended prior to requests for release of additional funds.
- Verify adequacy of indirect cost calculations and legitimacy of such costs per contract.
- Verify that there are adequate controls over sub-contractor payments.
- Test a sample of payroll costs against personnel records.

### **1.3.7. Contractor Payments**

#### **1.3.7.1. Advance Payments**

Any provider seeking the release of funds prior to the commencement of work under the contract should make such a request in writing, specifying the reason(s) advance funds are needed.

All requests for advance funding should be subject to the approval of the executive director or other designated agent of the commission, based on the nature of each project and the needs of the provider.

A cash advance should not exceed 50 percent of the maximum amount allowed under the contract.

Additional funds should not be released until 75 percent of previously released funds have been expended.

If at the end of the contract period (e.g., fiscal year) the provider has not utilized any portion of the funds advanced, the provider shall return that amount to the commission. If the amount is not returned, the commission can withhold funds from the subsequent year's contract (if there is one). The commission should make every attempt to negotiate a solution before pursuing litigation in the courts.

#### **1.3.7.2. Progress Payments**

The contract shall specify the procedures whereby providers may apply for and receive payment for services rendered to the commission. Every effort should be made to pay providers in a timely manner according to the terms of the contract.

The program handbook (see procedure on performance monitoring and reporting) should provide detailed instructions on how to apply for payment, including instructions on how to complete any forms to be used in the application process.

The commission should establish the intervals at which providers may request payment for services rendered (e.g., monthly, quarterly, tri-annually, annually, etc.).

Providers should formally request reimbursement for services by submitting an invoice. Depending on the type of contract and the level of review desired by the commission, the provider may be required to include with the invoice an expenditure report comparing actual expenditures to the project budget.

Payment of invoices should be contingent upon compliance with all contractual

requirements, including the achievement of performance standards and the timely submission of interim program and fiscal reports.

The release of funds to a provider should be approved by both program and financial staff. The program officer verifies that satisfactory progress has been made toward project objectives, as determined by the commission's performance monitoring and reporting system. The finance officer verifies that all reported expenditures are allowable under the terms of the contract.

An undisputed portion of an invoice should not be withheld pending the resolution of a disputed amount. If a portion of an invoice is in dispute, only the disputed portion should be withheld. The commission should pay the undisputed portions promptly.

## **1.4. MODEL DOCUMENTS**

- Request for proposals template
- Evaluation plan template
- Contract template
- Program handbook template
- Fiscal compliance audit form template

## **1.5. RESOURCES**

California State Contracting Manual

California Public Contract Code

California State Procurement Publications

California Association of Public Purchasing Officers

"Winning Compliance" by Peter Hutchinson and David Osborne

Assessing Risk in the State Expenditure Process - New York State Comptroller's Office

National Association of State Purchasing Officials

National Contract Management Association

National Institute of Governmental Purchasing

National Purchasing Institute

## CHAPTER 2: INVESTMENT MANAGEMENT

### 2.1. INTRODUCTION

The purpose of this chapter is to set forth general guidelines for the investment practices of First 5 commissions. Public fund investing includes short-term investments to meet daily cash flow requirements and long-term investments to meet future goals. These guidelines are based on current best practices in public investing and offer the flexibility necessary to accommodate different types and sizes of commissions.

In most cases, commissions will not be conducting day-to-day investment management, but will delegate this duty to investment professionals in the public or private sector. Most commissions currently delegate this duty to their county treasurer. However, in order to provide proper stewardship of public funds, it is important that commissions are familiar with fundamental investment concepts, play an active role in setting the goals and policies of their investment program, and monitor and oversee professional portfolio managers.

The content of this chapter is primarily based on GFOA Recommended Practices and publications as well as the *Local Agency Investment Guidelines: Update for 2005* produced by the California Debt and Investment Advisory Commission (CDIAC), which can be found at <http://www.treasurer.ca.gov/cdiac/LAIG/05guide-line.pdf>.

#### 2.1.1. Types of Investment Risk

All investments contain an element of risk. Below are the major types of investment risk.

**Credit (default) risk.** Credit or default risk is the risk that some or all of the principal amount of the investment will not be available due to default by the issuer, securities broker or dealer, or financial institution. Default risk can be controlled by carefully screening and monitoring the credit quality of issuers, brokers, dealers, and financial institutions; by limiting investments to those of the highest credit quality; and by insisting on holding collateral against certain investments. National credit rating agencies can provide ratings on securities such as commercial paper and bankers' acceptances. Bank rating agencies can provide ratings on financial institutions and savings and loan institutions. For more information, visit <http://www.fdic.gov/bank/individual/bank/>.

**Liquidity risk.** Liquidity risk involves the ability to sell an investment before maturity. Some short-term investment instruments are fairly illiquid. For example, a non-negotiable certificate of deposit is an illiquid asset that carries an interest penalty for early redemption. Another example of an investment that is illiquid before its final maturity is commercial paper. The ability to sell commercial paper prior to maturity is dependent on the willingness of the issuer to repurchase the paper from investors since there is no secondary market (the market where securities are sold after their initial issuance) for short-term commercial paper.

Closely related to liquidity risk is the concept of marketability—the ability to sell

an instrument on short notice without incurring a significant loss in price. An active secondary market will enhance an instrument's marketability.

**Market risk.** Market risk is the risk that changes in the financial market will reduce the value of a security. For example, as interest rates rise, bond prices will fall. In periods of rapidly rising interest rates, the market value of a debt instrument can fall below the principal amount invested. If a government sells the security before maturity, part of the principal will be lost. This was the case with mortgage-backed derivative products whose values plunged below the par value (face value) of the securities in the fall of 1994. Investors can reduce market risk by limiting the number of instruments in the portfolio that are subject to rapid market swings.

**Interest rate risk.** Interest rate risk is the risk that investors will be holding an investment with a lower yield than the current market rate and, hence incur an opportunity cost by under performing the market. For example, if an investor held a one-year certificate of deposit earning 5 percent and interest rates rose to 7 percent, the investor would incur an opportunity cost of 2 percent. Investors can avoid interest rate risk by keeping maturities fairly short if interest rates are expected to rise.

## 2.2. POLICY STATEMENT

The primary objectives of the investment activities of First 5 commissions, in priority order, are legality, safety of principal, liquidity, and yield.

- *Legality* – The investment program must conform to federal laws, state statutes, local ordinances, and internal policies and procedures.
- *Safety of principal* – Commissions must take care to ensure the preservation of capital and the protection of investment principal.
- *Liquidity* – Commissions must maintain sufficient liquidity to meet operating requirements. Investment of operating funds in long-term maturities or illiquid instruments should be considered only if it is clearly demonstrated that these funds will not be required for operating needs.
- *Yield* – The investment portfolio should earn a market rate of return. Funds that may not be required for short-term liquidity should be invested to safely enhance yield. Investment officers should be encouraged to earn the highest yields possible consistent with safety of principal and liquidity requirements.

## 2.3. PROCEDURES

### 2.3.1. Written Investment Policy

Commissions should have a written investment policy that specifies acceptable investment instruments and establishes an acceptable level of risk related to return.

### 2.3.1.1. Content of the Investment Policy

California law contains no provisions specifying what must be included in a local agency's investment policy. However, the investment policy of a county government must contain the following:

- A list of securities or other instruments in which the county treasury may invest, according to the law, including the maximum percentage by type of security, and the maximum term of any security purchased.
- The manner of calculating and apportioning the authorized costs of investing, depositing, banking, auditing, reporting, handling, and managing of funds.
- Limits on the receipt of honoraria, gifts, and gratuities for county treasury oversight members from advisors, brokers, dealers, bankers, or other persons with whom the county treasury conducts business.
- Criteria for selecting brokers and dealers (including prohibitions against selecting any broker, dealer, or security firm within any consecutive 48 month period of making a campaign contribution exceeding the limitations contained in Rule G-37 of the Municipal Securities Rulemaking Board).
- A requirement that the treasurer provide the county treasury oversight committee with an investment report as required by the Board of Supervisors.
- Terms and conditions under which other local agencies that are not required to deposit funds may deposit funds in the county treasury if they so choose.
- Criteria for considering requests to withdraw funds from the county treasury.

According to the GFOA Sample Investment Policy, an investment policy should cover the following topics:

- Governing authority of the investment program
- Scope of investment policy
- General objectives of investment activities (safety, liquidity, yield)
- Standards of care (prudence, ethics and conflicts of interest, delegation of authority)
- Authorized financial institutions, depositories, and broker/dealers
- Safekeeping, custody, and internal controls
- Suitable and authorized investments and collateralization
- Investment parameters (diversification, maximum maturities, competitive bids)
- Reporting (methods, performance standards, marking to market)

- Policy consideration
- Approval of investment policy

#### 2.3.1.2. Submitting the Investment Policy to the Commission

California law, Government Code Section 53646(a)(2) requires the treasurer or chief fiscal officer of any local agency to annually render to his/her legislative body an investment policy and, if applicable, his/her oversight committee, which the legislative body shall “consider” at a public meeting. The investment policy must be an agenda item at a public meeting of the agency’s legislative body at some time prior to or during the year it covers. More specifically, section 53646(b)(2) states “The quarterly report shall state compliance of the portfolio to the statement of investment policy...”, which implies that the investment policy must be an agenda item at a public meeting prior to completion of the first quarterly report of the year. The law does not place specific approval requirements on local agencies, nor does it specify when during the year that consideration or approval must occur.

#### 2.3.2. Responsibility for Investment Management

For commission funds invested in the county treasury, the county treasurer serves as a fiduciary and is subject to the prudent investor standard. Except as provided for in Government Code Section 27000.3, Section 53600.3 declares each person, treasurer, or governing body authorized to make investment decisions on behalf of local agencies to be a trustee and therefore a fiduciary subject to the prudent investor standard. These persons shall act with care, skill, prudence, and diligence under the circumstances then prevailing when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing funds.

Government Code Section 53686 requires that reports and/or audits concerning investments that are prepared by county treasurers must be provided to local agencies that have funds deposited in the county’s investment pool.

Section 53600.5 stipulates that the primary objective of any person investing public funds is to safeguard principal; secondly, to meet liquidity needs of the depositor; and lastly, to achieve a return or yield on invested funds.

According to Section 53600.3, the commission can delegate *duties* to an external money manager via a principal-agent relationship, but they cannot delegate *fiduciary responsibility*. Further, to be consistent with best practice, contracts with external managers should allow them to make specific decisions within an established framework. Commission executive directors or their designated representatives should closely monitor the actions of these individuals to ensure they are consistent with the commission’s investment policy and philosophy, and demand that external managers provide timely reports that comply with the requirements of state law.

#### 2.3.3. Permissible Types of Investments

*Model Allowable Investment Instruments* and *Model Allowable Short-Term Investment Instruments* provide a synopsis of the permitted securities and condi-

tions for using them (Sections 16429.1, 53601, 53601.6, 53601.7, 53635, 53635.2, and 53684). Best practice is for the commission to select investments from this list in order to make its own list of permissible investments based on its unique needs and risk tolerance.

In addition to the allowable investments listed in *Model Allowable Investment Instruments* and *Model Allowable Short-Term Investment Instruments*, money may be deposited for safekeeping in the following (Section 53635.2):

- State or national banks
- Savings associations
- Federal associations
- Credit unions
- Federally insured industrial loan companies in California

To be eligible to receive local agency money, the financial institution must receive an overall rating of not less than “satisfactory” from the appropriate federal supervisory agency for meeting the criteria specified in Section 2906 of Title 12 of the United States Code (Community Reinvestment Act of 1977). The Community Reinvestment Act of 1977 requires financial institutions to demonstrate their commitment to meeting the credit needs of local communities in which they are chartered to do business. For the purpose of the Act, the appropriate federal supervisory agency includes:

- The Comptroller of the Currency with respect to national banks.
- The Board of Governors of the Federal Reserve System with respect to state chartered banks that are members of the Federal Reserve system and bank holding companies.
- The Federal Deposit Insurance Corporation with respect to state chartered banks and savings banks that are not members of the Federal Reserve System and the deposits of which are insured by the FDIC.
- The Director of Office of Thrift Supervision with respect to savings associations, the deposits of which are insured by the FDIC, and savings holding companies.

A local agency would need to contact the appropriate federal supervisory agency to determine if its financial institution meets the overall rating requirement.

Prohibited investments include securities not listed in *Model Allowable Investment Instruments* and *Model Allowable Short-Term Investment Instruments*, as well as inverse floaters, range notes, interest-only strips derived from a pool of mortgages, and any security that could result in zero interest accrual <sup>1</sup> if held to maturity, as specified in Section 53601.6.

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<sup>1</sup> Zero-interest accrual means the security has the potential to realize zero interest depending upon the structure of the security. Zero coupon bonds and similar investments that start at a level below the face value are legal because their value does increase.

Where the Government Code specifies a percentage restriction on a certain category of investment, this share of the investment portfolio must be in compliance with state law at the time that investment is purchased. The law does not specify that the entire portfolio must be in compliance when new instruments are purchased. It also does not require “rebalancing” in the case where subsequent maturities, sales, withdrawals, or similar non-purchase activities result in the remaining portfolio having one or more of the categories of investment rise above the percentage restrictions applicable at the time of purchase.

In addition, Government Code Section 53601.7 specifies (for investments purchased pursuant to this section) that any credit rating downgrade of an investment subsequent to purchase shall result in the security being reviewed for possible sale within a reasonable amount of time after the downgrade.

#### 2.3.4. Maturities of Investments

According to best practice, the commission should attempt to match its investments with its anticipated cash flow requirements. In other words, funds needed to meet cash flow requirements in the near future should be invested in more liquid, short-term investments, while reserve funds intended to be used in future years should be invested in longer-term investments that still preserve the safety of the principal and match cash flow requirements, but earn higher returns.

According to California law, there is a five-year maturity limit on permissible investments. However, local agencies may invest funds in securities with maturities exceeding five years if the local agency’s legislative body specifically approves the investment no less than three months prior to the purchase of the security (Government Code Section 53601). Part of that approval process involves assessing and disclosing the risk and possible volatility of longer-term investments.

According to best practice, reserve funds and other funds with longer-term investment horizons may be invested in securities exceeding five years if the maturities of such investments are made to coincide as nearly as practicable with the expected use of funds. Because of inherent difficulties in accurately forecasting cash flow requirements, a portion of the commission’s total investment portfolio should be continuously invested in readily available funds such as local government investment pools, money market funds, or overnight repurchase agreements to ensure that appropriate liquidity is maintained to meet ongoing obligations.

##### *Ability of some commissions to invest funds in longer-term investments.*

Commissions that are county agencies are controlled by their counties’ investment policies and procedures. County governments typically make relatively short-term investments in order to meet cash flow requirements, and this approach is reflected in their policies and practices. However, based on some commissions’ long-term plans for use of reserve funds and consequent lower liquidity requirements for the total amount available for investment, it may be possible to work with a county’s investment managers and policy makers to implement changes in policy and procedure that maintain the safety of principal and meet commissions’ liquidity requirements, but earn higher yields.

### 2.3.5. Internal Controls for Investment Management

An important step toward the prudent investment of public funds is to organize and formalize investment-related activities. Internal controls for the investment function are important to safeguard the commission's assets (cash and securities) and to ensure accurate and timely financial reporting. The commission's assets need to be protected not only from theft, fraud, and embezzlement, but also from inappropriate or poor decision-making.

To control the investment function, the local commission should rely on a combination of organization designs, systems and procedures. These can be summarized as follows:

- Written investment policy
- Formal written agreements
- Organizational design
- Separation of duties
- Barriers to collusion
- Checks and balances
- Pre-employment screening
- Documentation of procedures
- Training
- Reporting requirements
- External monitoring
- Paper systems
- Electronic fund transfer procedures and wire transfer agreements
- Internal loss controls
- Cost-benefit analysis

The model documents section of this manual contains a checklist of internal controls for the investment function.

### 2.3.6. Safekeeping

According to California law (Sections 53601 and 53608), as long as the securities for safekeeping are in the name of or under the control of the agency and kept in a legally separate trust department, they can be held by the same firm from which they were purchased.

However, best practice is to use a safekeeping service that is not related in any way to the company who sold the securities. Agencies should strive to “perfect” the delivery of securities purchased by avoiding situations in which a relationship exists between the broker-dealer and safekeeping provider. Even in situations when the safekeeping function is in a subsidiary or trust department that is legally independent of its parent company, strong ties between the two may remain. In the event that the parent company fails, local agencies may have some difficulty in regaining possession of their securities from the subsidiary or trust department.

### 2.3.7. Investment Performance Benchmarks

The commission will select investment performance benchmarks that match its legally authorized investments, investment policy constraints, and cash flow requirements.

It may be appropriate to segregate the commission's total investment portfolio into more homogenous types of investments. For example, the commission might have one benchmark for its short-term cash investments and a separate benchmark for its long-term reserves.

Below are two sources of investment rate of return data and an assessment of California local government investment pools:

- State Treasurer Local Agency Investment Fund
- Historical Interest Rate Data
- Assessment of Local Government Investment Pools: A Survey of California County Pools, California Debt and Investment Advisory Commission

### 2.3.8. Investment Reporting to the Commission

Government Code Section 53646 requires all local agencies to file investment reports on the status of their investment portfolios with their respective legislative body, internal auditor, and chief executive officer.

#### *When report must be submitted*

The report must be submitted within 30 days after the end of the quarter. The commission may elect to require the report monthly.

#### *What the report must include*

The investment report must include the following information:

- Investment type, issuer, date of maturity, par value, and dollar amount invested in all securities, investments, and monies held <sup>2</sup> by the commission.
- A description of the funds, investments, and programs (including lending programs) managed by contracted parties. <sup>3</sup>
- A market value of the overall portfolio as of the date of the report and the source of the valuation. <sup>4</sup>

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<sup>2</sup> This includes all of the securities, investments and monies for which the local agency exercises control or are in its possession. Control implies that the local agency has some discretion to determine how the funds are invested. Possession implies that the local agency has at least a safekeeping role. This standard ensures the broad reporting of local agency investments contemplated by the Legislature. Thus, the report should include the following items:

- agency cash, whether invested directly by the agency or by a contract investment manager;
- locally managed pension funds;
- locally managed deferred compensation funds;
- bond funds, because local agencies have the right to direct their investment; and
- endowments and other trust funds.

<sup>3</sup> Best practice recommends that the name of the investment managers and the nature of the contracts also be reported.

- A statement of compliance with the investment policy or an explanation for noncompliance.
- A statement of the ability or inability to meet expenditure requirements for six months, as well as an explanation of why money will not be available if that is the case.<sup>5</sup>
- Any other additional information that the commission elects to receive.

*When the investment report is not required*

This investment report is not required if all of the commission's funds are deposited in the following types of investments:

- The county treasury
- The Local Agency Investment Fund (LAIF) maintained by the State Treasurer
- FDIC-insured bank deposits
- National Credit Union Shared Insurance Fund-insured accounts in a credit union
- Accounts insured or guaranteed pursuant to California Financial Code Section 14858
- Some combination of the above

If all of the commission's funds are deposited in the above types of investments, in place of an investment report, the following information must be submitted to the legislative body, internal auditor, and chief executive officer:

- The most recent account statement for the investment.
- A statement of compliance with the investment policy or an explanation for

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<sup>4</sup> The market valuation data in the report should represent the agency's best available information and fairly represent the value of the portfolio, in the judgment of the investment officer. According to best practice, staff should obtain an independent valuation of the portfolio to provide the most unbiased method of reporting current market values. In situations where an agency's budget does not allow independent valuations, the agency should use the best available sources of market price information available. A system can be created to track prices from different sources over time to evaluate the sensitivity of price estimates, but there is no standard for accuracy. Prices for securities are estimates that carry a certain degree of error regardless of the approach used and they will fluctuate due to market conditions over time. It is imperative that local officials pay extra attention to estimates on complex, infrequently traded, or highly customized securities.

<sup>5</sup> Best practice recommends that staff regularly prepare and update a cash flow analysis to justify the expenditure statement in the report. This analysis may list basic projections—based on historical data, market sensitivity or other relevant information—that support the cash flow liquidity statement. There are no guarantees when it comes to predicting future obligations. A sound justification for the expenditure statement gives the finance officer added protection against decisions that originally looked good but turned out poorly because of unforeseen circumstances. The treasurer should be prepared to discuss cash flow projections and methodology at the request of legislative and/or oversight bodies.

noncompliance.

- A statement of the ability or inability to meet expenditure requirements for six months, as well as an explanation of why money will not be available if that is the case.

### 2.3.9. Selection of Investment Advisors

The services of investment advisors range from advice-only consultation to fully discretionary management. The Government Finance Officers Association (GFOA) recommends that state and local governments exercise caution and prudence in their selection of investment advisers, particularly because the responsibility for safety and liquidity of governmental funds cannot be delegated to an investment advisor. (An excellent resource on selecting and evaluating investment advisors is GFOA's *An Introduction to Investment Advisors for State and Local Governments*.)

GFOA urges state and local governments considering or retaining an investment advisor to develop policies regarding the procurement and periodic selection of investment advisory services.

In accordance with state and local law or other requirements, these policies should address the following:

1. The responsible public official or the governing board should appoint a consultant and/or review committee to conduct the search process. Such consultant and/or review committee members should be independent and free of any special interests in any investment advisory firm under consideration.
2. A competitive, merit-based procurement process for selection should be employed.
3. Responsibilities of the investment adviser and/or investment manager should be stated.
4. The consultant and/or review committee should determine the criteria to be used in the selection. Criteria should include but are not limited to:
  - Investment style
  - Years in business
  - Assets under management
  - Investment performance versus appropriate benchmarks over an agreed upon period of time
  - Delivery of SEC Form ADV Part I and Part II (including Schedule I) prior to contract execution
5. The consultant and/or review committee should determine the sources for candidates to be considered, including but not limited to:
  - Consultants database(s) on investment advisory firms
  - Industry reports and articles
  - Marketing materials

- References from other jurisdictions
  - Special research and reports in order to ensure diversity in candidate pool
  - Other governmental entity resources and information
6. The consultant and/or review committee should perform due diligence on candidates, including but not limited to:
- Quantitative information (financial stability and performance review)
  - Organizational structure of firm
  - Experience and depth of personnel in firm, including turnover
  - Firm-specific investment philosophy and portfolio management strategies
  - Trading process
  - Management fees
  - References from other clients
  - Interviews with finalists
  - Use of a request for proposal (RFP) process

After the consultant and/or review committee has made a recommendation regarding the selection of an investment advisor, the contract process should include the following:

- Establishment of account responsibility
- Assignment of management and fiduciary responsibility
- Determination of professional liability insurance for crime, errors, and omissions
- Establishment of fee and terms of invoicing and payment
- Procedure for termination of contract by either party
- Specifications related to nondiscrimination in contracting and ethics rules
- Certification that the investment adviser has read and understood the investment policy
- Compliance with appropriate laws and regulations at both the state and local levels

The finance officer managing the investment advisor contract should comply with the following ethical considerations:

- Adherence to all of the jurisdiction's ethics laws, rules and regulations related to procurement and involvement with contractors, including those related to political contributions
- Disclosure to jurisdiction of any inherent or potential conflicts of interest in dealing with specific investment advisors prior to taking any official action
- Adherence to the GFOA Code of Professional Ethics

The commission should develop and implement an ongoing risk control program, including:

- Ongoing compliance reviews
- Delivery versus payment
- Third-party custody
- Prohibitions against self-dealing
- Independent audits
- Timely reconciliations
- Maintaining current documentation of the investment advisor's internal controls audit
- Other appropriate internal control measures

## **2.4. MODEL DOCUMENTS**

- Sample Investment Policy (GFOA)
- A Checklist of Internal Controls for the Investment Function
- Investment Procedures and Internal Controls Guidelines (GFOA)
- Model Investment Policy and Guidelines for an Investment Procedures Manual (Association of Public Treasurers of the United States and Canada)
- Model Allowable Investment Instruments
- Model Allowable Short-Term Investment Instruments

## **2.5. RESOURCES**

- California Debt and Investment Advisory Commission
- Local Agency Investment Guidelines: Update for 2005 (California Debt and Investment Advisory Commission)
- Understanding Public Investment Reporting: A Handbook for Local Elected Officials (California Debt and Investment Advisory Commission)
- Investment Portfolio Reporting Practices: An Informational Guide (California Debt and Investment Advisory Commission)
- Preparing Requests for Proposals (California Debt and Investment Advisory Commission)
- *An Elected Officials Guide to Investing* (Available through GFOA's online publications catalog)
- *Investing Public Funds* (Available through GFOA's online publications catalog)
- GFOA Recommended Practice: "Maturities of Investments in a Portfolio"

- GFOA Recommended Practice: “Selection of Investment Advisers for Non-Pension Fund Assets”
- *An Introduction to Investment Advisors for State and Local Governments* (Available through GFOA's online publications catalog)
- “Back to Basics: Making the Case for Investment Policies,” *Government Finance Review*, August 2000, p.20-23. (GFOA)
- “GFOA’s New Model Investment Policy,” *Government Finance Review*, December 2003, p. 41-46. (GFOA)
- “Effective Matching of Maturities to Cash Flow Requirements,” *Government Finance Review*, October 2003, p. 50-51. (GFOA)

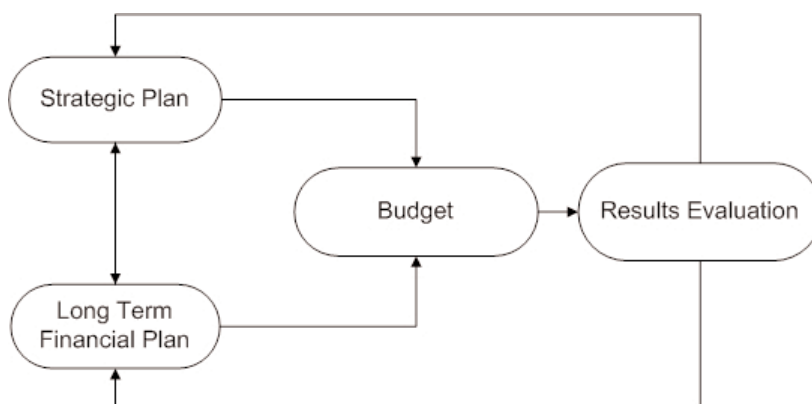
## CHAPTER 3: PLANNING AND BUDGETING

### 3.1. OVERVIEW - LINKING THE STRATEGIC PLAN, LONG-TERM FINANCIAL PLAN, AND THE BUDGET

In its strategic plan, a commission sets goals and objectives and develops strategies for achieving them. In its long-term financial plan (some commissions call this a “sustainability plan”), a commission takes a long-term view of its financial situation and makes tentative plans for allocating future resources to the objectives identified in the strategic plan. In its budget, a commission makes a commitment for how resources will be used in the short term, typically the upcoming one or two fiscal years. The budget is a short-term spending and operational plan shaped by the goals and objectives in the strategic plan and the financial direction set in the long-term financial plan. The evaluation process includes both the evaluation of financial results and program performance.

This chapter is divided into three sections: strategic plan, long-term financial plan, and budget. Financial results are addressed in the chapter on financial reporting. This handbook does not include procedures for program and strategic results evaluation.

The following diagram illustrates the linkage among the strategic plan, long-term financial plan, the budget, and evaluation of results.



### 3.2. STRATEGIC PLAN

#### 3.2.1. Introduction

A commission develops the strategic plan through a collaborative process that includes its stakeholders. Based on an assessment of the environment, a strategic plan includes goals, objectives, and strategies for achieving those objectives. The California Children and Families Act of 1998 includes requirements for developing a strategic plan.

#### 3.2.2. Policy Statement

Commissions will develop and adopt an adequate and complete strategic plan for

the support and improvement of early childhood development within the county. The strategic plan will use a collaborative process and be in compliance with state law and the guidance of the State of California First Five Commission.

### 3.2.3. Procedures

The procedures presented below are an assembly of directives enumerated in the California Health and Safety Code (130000-130155) and State Commission guidelines for implementing the California Children and Families Act (September 1999). Relevant procedures related to strategic planning includes:

- A commission must conduct at least one public hearing on its proposed county strategic plan before the plan is adopted. (Section 130140(1)(D))
- A commission's strategic plan must be consistent with and in furtherance of the purposes of the Act (Proposition 10) and any guidelines adopted by the State Commission at the time the plan is adopted. (Section 130140(1)(C)(i))
- A commission's strategic plan must recognize that revenue allocations from the State Commission will be used only to supplement existing levels of service and not to fund existing levels of service. The strategic plan must recognize that no moneys in the California Children and Families Trust Fund will be used to supplant state or local general fund money. (Section 3031.4)
- The strategic plan must be formally adopted by the commission. The adopted strategic plan must be an adequate and complete plan for the support and improvement of early childhood education within the county. (Section 130140(1)(C))
- A commission must submit its adopted county strategic plan and any subsequent revisions to the State Commission. (Section 130140(1)(F))

The following are the required components of a strategic plan (Section 130140(1)(C)(ii)):

- A description of the goals and objectives proposed to be attained.
- A description of the programs, services, and projects proposed to be provided, sponsored, or facilitated.
- A description of how measurable outcomes of such programs, services and projects will be determined by the commission using appropriate and reliable indicators.
- A description of how programs, services, and projects relating to early childhood development within the county will be integrated into a consumer-oriented and easily accessible system.
- A budget that shows estimated allocations to the various program components that support the commission's goals for early childhood development.

### **3.2.4. Model Documents**

- San Mateo Strategic Plan Revision 2004
- San Diego County 2004-2009 Strategic Plan

### **3.2.5. Resources**

- *Guidelines: A Resource for Development of Proposition 10 Strategic Plans* (California Children and Families Commission)
- *Guidance to County Commissions on Allocating California Children and Family Act (Proposition 10) Funding* (California Children and Families Commission)
- *A Guide to Updating Your Proposition 10 Strategic Plan* (Santa Barbara County)
- Overview of Eight Diverse Strategic Plans

## **3.3. LONG-TERM FINANCIAL PLAN**

### **3.3.1. Introduction**

A commission's long-term financial plan illustrates the likely financial outcomes of particular courses of action or factors affecting the environment in which it operates. Such a financial plan is not a statement of what is certain to happen but rather a device to highlight significant financial and operational issues or problems that must be addressed if goals are to be achieved. Long-term financial planning expands a government's awareness of options, potential problems, and opportunities. It helps decision makers to see the long-term implications of expanding or reducing existing programs, and helps decision makers to take corrective action before potential problems become more severe. Decision makers should use the plan as a resource when making decisions in the budget.

### **3.3.2. Policy Statement**

Commissions should develop a long-term financial plan. The plan should assess the long-term financial implications of current and proposed policies, programs, and assumptions. It should provide a long-term view of how resources will be allocated to the objectives in the strategic plan.

### **3.3.3. Procedures**

The following procedures provide commissions a recommended approach to long-term financial planning, including components, content, and commission-specific activity. Specific procedures:

1. Develop a plan that includes the following components:
  - An analysis of past financial trends.

- An assessment of the problems and opportunities the commission will face in the future and actions needed to address these issues.
  - Long-term forecasts of future revenues and expenditures that use alternative economic, planning, and policy assumptions.
  - A plan for total revenue and expenditure levels for the planning period.
  - A plan for allocating resources among the objectives in the strategic plan. (Some commissions may also want to provisionally allocate resources to specific programs.)
2. The financial plan should include forecasts of future revenues, expenditures, and reserves for a period of at least six years.
  3. The financial plan should include future revenue and expenditure levels in a likely scenario. In this plan, expenditures should not exceed available revenues and reserves during the planning period.

The financial plan should include a thorough assessment of the “revenue risk” attached to the Proposition 10 tobacco tax funding stream. Such attention is warranted as state level revenue modeling and analysis projects a decline of tobacco tax revenue in future years.

The importance of this assessment is further underscored by the Proposition 10 requirement that local commissions promote tobacco cessation programs, while relying upon tobacco tax dollars to provide a substantial portion of their revenue.

4. The financial plan, though not a binding commitment like the budget, should be adopted by the commission to show its intent to allocate funds in future budget periods.
5. The financial plan should be updated every year in concert with budget preparation.

#### **3.3.4. Model Documents and Examples**

- Long-Term Financial Plan
- Financial Planning Template Spreadsheet (San Diego First 5 Commission)
- Five-Year Community Investment Plan (Santa Clara County Commission)
- Long-Term Financial Plan (Salano County Commission)

#### **3.3.5. Resources**

- Conduct Long-Range Financial Planning (NACSLB Recommended Practice)
- Financial Forecasting in the Budget Preparation Process (GFOA Recommended Practice)

- Proposition 10 Financial Planning Guidebook

## 3.4. BUDGET

### 3.4.1. Introduction

The budget is a commitment for the allocation of available resources for the upcoming budget period. The budget is shaped by the goals and objectives contained in the strategic plan and the financial direction set in the long-term financial plan. The budgeting policies and procedures presented here cover both the written budget document and the decision-making process for developing the budget. The purpose of this section is to set forth general guidelines for the allocation of Proposition 10 funds—guidelines grounded in best practices in budgeting but reflecting the flexibility necessary to accommodate different types and sizes of commissions.

### 3.4.2. Policy Statement

Commissions should use an outcome-based budget process that reflects the essential features of a good budget process identified by the National Advisory Council on State and Local Budgeting:

- Incorporates a long-term perspective
- Establishes linkages to broad organizational goals
- Focuses budget decisions on results and outcomes
- Involves stakeholders and promotes effective communication with them

### 3.4.3. Procedures

Specific procedures are detailed below.

#### 3.4.3.1. Establish a Process for Preparing and Adopting a Budget

##### 3.4.3.1.1. *Annual and Multi-year Budgeting*

The commission should consider adjusting the time period of the budget to a period (e.g., 12 months, 24 months, 36 months, etc.) that best fits its needs within the constraints imposed by its county government and state law. An annual budget authorizes a government's planned revenues and expenditures for one year. A multi-year budget authorizes a government's planned revenues and expenditures for two or more consecutive budgetary years.

Multi-year budgets tend to be more beneficial for organizations with predictable revenues and expenditures, such as First 5 commissions. Thus, if a commission is limited by its county government to adopt an annual budget, it might still produce detailed estimates of revenue and expenditures over multiple years for planning purposes, but only adopt the first year as the formal budget. Commissions should consider the advantages and disadvantages of multi-year budgeting and select a

time period that best fits their needs.

#### **3.4.3.1.2. Budget Calendar**

The commission's budget process should be guided by a written budget calendar. The budget calendar is a schedule that lists the dates of key budget events and deadlines. It specifies the key budget tasks in the budget process, when they must be completed, and who is responsible for completing each task. The budget calendar describes the procedure for preparing, reviewing, and adopting the budget. The budget calendar should be distributed to budget stakeholders early in the budget process.

### **3.4.3.2. Budget Process**

#### **3.4.3.2.1. Overview of Budget Process**

The commission's budget process should follow the following key steps:

1. Commission holds a community meeting to obtain stakeholder input on the upcoming budget period.
2. Staff prepares background information for the commission planning session.
3. In a planning session, the commission sets priorities for the upcoming budget period and adopts a long-term financial plan.
4. Staff prepares proposed budget based on priorities set in commission planning session.
5. Commission reviews the proposed budget.
6. Commission approves the budget.
7. Adopted budget communicated to stakeholders using popular budget.
8. Staff administers and monitors budget.
9. Authorized party amends the adopted budget as necessary.

#### **3.4.3.2.2. Community Input Session(s)**

The commission should hold one or more community input sessions to obtain stakeholder input on priorities for the upcoming budget period. The commission's strategic plan should serve as the framework for this input session. To avoid duplicate meetings with similar purposes, the commission may choose to hold community meetings for purposes of program and budget planning.

#### **3.4.3.2.3. Commission Planning Session**

The commission should have a planning session to make tentative long-term financial plans and to set priorities for the upcoming budget period. The inputs of this session should be the strategic plan, the proposed long-term financial plan, the summary of the commission's most recent financial and performance information,

and the summary of stakeholder input.

Staff should prepare background information for a commission planning session. This background information should include:

- A summary of the stakeholder input from the community input session.
- A summary of the commission's most recent financial and performance information.
- Staff recommendations for long-term plans for meeting the objectives in the strategic plan.
- A proposed long-term financial plan (or an update to an existing plan).

#### **3.4.3.2.4. Preparation of Proposed Budget**

Staff should prepare a proposed budget based on the priorities set in the local commission planning session.

Commission management's responsibility generally is to present the proposed budget in a way that best facilitates effective resource allocation decisions by the commission. It should show anticipated resources and how these resources will be used to carry out the objectives in the strategic plan. In other words, it should present financial information in a format that helps decision makers to ensure that their funding decisions will support the purposes they have outlined in their strategic plan.

The budget document should include the following sections:

- *Budget Summary* – The beginning of the budget document should include a budget summary that gives the “big picture” and highlights key information in the budget such as important changes in revenues, expenditures, and reserves.
- *Tables* – Tables should present financial data in a format that shows how resources will be used to carry out the objectives in the strategic plan. Tables should include at least three years of financial data (prior year actual, current year estimated, next year proposed budget).
- *Budget Narratives* – The budget document should include budget narratives that provide the assumptions behind the budget estimates, explain significant changes in budget line items, explain how the resource allocation in the budget relates to the goals and objectives in the strategic plan, and “tell the story behind the budget numbers.”

The budget document should also include a clear definition of the basis of accounting used for budgetary purposes. If the budgetary basis of accounting and the GAAP basis of accounting are the same, this fact should be clearly stated. If the budgetary basis of accounting and the GAAP basis of accounting are different, major differences and similarities between the two bases of accounting should be noted. Disparities may include basis differences, timing differences, fund structure differences, and entity differences.

#### **3.4.3.2.5. Commission Review of Proposed Budget**

The commission should review the proposed budget prior to adoption. The commission should use the strategic plan and the long-term financial plan as the framework for its review.

#### **3.4.3.2.6. Budget Adoption**

The commission should adopt the proposed budget at least one month prior to the beginning of the next budget period. In the adopted budget, the operating expenditures must not exceed the operating resources (forecasted revenues and reserves).

#### **3.4.3.2.7. Communicate Budget to the Public through a Popular Budget**

The commission should prepare a “popular budget” document that meets the following objectives:

- Provides a “big picture” view of the budget and highlights the most important budgetary information.
- Effectively communicates budgetary information in a clear, user-friendly format using charts, tables, and/or narrative when appropriate.
- Clearly shows how the funding decisions in the budget will be used to carry out the objectives in the strategic plan.
- Presents a long-term financial view.
- Explains the need for reserves or fund balance.

#### **3.4.3.2.8. Budget Administration**

Staff should administer and monitor the adopted budget. Staff should use the budget document as a guide for expenditures throughout the budget period so that actual expenditures do not exceed the total adopted budget, resources are used for the appropriate purposes, and resources are not expended too quickly.

#### **3.4.3.2.9. Budget Amendments**

The commission should make amendments to the adopted budget as necessary. Any changes to the total amount of the budget must be approved in writing by the commission prior to recording the change. Changes within the total amount of the budget do not need to be approved by the commission; however, the executive director must approve the change and the commission must be notified in writing after the change.

### **3.4.4. Model Documents and Examples**

- Budget Calendar
- Budget Format Templates

- Popular Budget: “Budget at a Glance”
- Budget Retreat Presentation (Santa Clara County Commission)
- Budget Packet (Santa Clara County Commission)
- Committee Budget Presentation (Santa Clara County Commission)
- Budget Narrative (Stanislaus County Commission)
- Proposed Operating Budget (Stanislaus County Commission)
- Proposed Budget – Contract Schedule (Stanislaus County Commission)
- Balance of Reserves (Stanislaus County Commission)

### **3.4.5. Resources**

- Recommended Practices of the National Advisory Council on State and Local Budgeting (NACSLB)
- “Best Practices in Budgeting: Putting NACSLB Practices into Action,” *Government Finance Review*, April 2000, p. 9-17. (GFOA)
- Providing a Concise Summary of the Budget (GFOA Recommended Practice)
- Measuring the Cost of Government Service (GFOA Recommended Practice)
- Relationship Between Budgetary and Financial Statement Information (GFOA Recommended Practice)
- *An Elected Official’s Guide to Multi-Year Budgeting* (Available through GFOA's online publications catalog)
- “Taking the Plunge: The Conversion to Multi-Year Budgeting,” *Government Finance Review*, August 2000, p. 24-27. (GFOA)

## CHAPTER 4: ACCOUNTING

### 4.1. INTRODUCTION

The purpose of this chapter is to provide key accounting policies and procedures for use by First 5 commissions.

The law establishing the state and local commissions requires a high level of accountability. All expenditures made by a commission must be for the purposes for which the commission was created, and in accordance with the approved commission strategic plan. As a recipient of federal, state, and other grant funds, program accounting is needed. In addition, the California Children and Families First Act requires outcome-based accountability.

Generally accepted accounting principles (GAAP) ensure the credibility and reliability of information that is critical to public support. GAAP for local governments have been established and maintained by the Governmental Accounting Standards Board (GASB). The Government Finance Officers Association (GFOA) plays a significant role in interpreting and teaching GAAP. GAAP and accounting best practices, as well as legal requirements, underlie the following policies and procedures.

### 4.2. POLICY STATEMENT

Accounting policies provide high-level guidance and focus attention on critical executive responsibilities associated with accounting. Accounting policies create the environment and culture in which commission management and staff make numerous decisions and take action on a daily basis. Following are the key accounting policies suggested for First 5 commissions:

1. Accounting is conducted in accordance with GAAP as promulgated by the GASB, and in accordance with the guidance in *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)* published by GFOA.
2. Accounting transactions are recorded in a manner to facilitate outcome-based accountability.
3. Accounting procedures and records ensure expenditures are made only for the purposes authorized by the California Children and Families Act of 1998 (as amended), and in accordance with the commissions' approved strategic plans.
4. Accounting procedures are adopted and followed to safeguard financial resources.

### 4.3. GENERAL ACCOUNTING PROCEDURES

Every commission should adopt a set of general accounting procedures to account for commission financial resources and record revenues and expenditures. The following general accounting procedures comprise the major elements that define and drive the accounting system:

- Generally accepted accounting principles
- Fund accounting
- Modified accrual basis of accounting
- Account classification
- Program accounting
- Cost allocation
- Budgetary control
- Internal control

Commissions that adopt these general accounting procedures will be well positioned to implement the accounting policies discussed above and meet the reporting criteria presented in the financial reporting chapter. Accounting guidance for asset, liability, revenue, and expenditure/expense accounts is presented in Section 4.4 of this chapter.

#### **4.3.1. Generally Accepted Accounting Principles (GAAP)**

Commission accounting policies, practices, and systems should conform to generally accepted accounting principles in order to maintain public trust in commission operations and reporting. When new accounts are created or changes in accounting practices are made, commissions need to ensure that they continue to comply with GAAP.

The primary source of GAAP for the public sector is the GASB, an independent standard-setting body operating under the auspices of the Financial Accounting Foundation. GAAP for the public sector is not the same as GAAP for the private sector. GASB issues accounting standards that ensure governmental accounting and reporting is conducted effectively and in the public interest.

The GASB is aided in its work by the Governmental Accounting Standards Advisory Council (GASAC), a consultative body made up of representatives of major groups interested in governmental accounting and financial reporting, such as GFOA and the American Institute of Certified Public Accountants (AICPA).

#### **4.3.2. Fund Accounting**

Government accounting systems are organized and operated on a fund basis to provide strong accountability for the use of public funds. GASB defines the term “fund” as follows:

A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulation, restriction, or limitations.

Fund accounting focuses on the inflow and use of current financial resources, whereas private sector accounting focuses on profit and net worth. Commissions are government entities that are required to use fund accounting.

Fund accounting includes three broad classifications of funds. Governmental funds

typically are used to account for tax-supported activities (commissions' activities are generally tax supported activities, therefore commissions would use a governmental fund.) Proprietary funds are used to account for a government's business-type activities like a water department or an airport. Fiduciary funds are used to account for resources that are held by the government as a trustee or agent for parties outside the government. Fiduciary funds cannot be used to support the government's own programs.

One type of governmental fund is the general fund. The general fund is the chief operating fund of most governments and is used by First 5 commissions. Another type of governmental fund is the special revenue fund. A special revenue fund accounts for the proceeds of a specific revenue source that is restricted by law or administrative action to be expended only on a specified purpose(s). Special revenue fund accounting is commonly used when revenue sources are exclusively designated for a specific purpose.

Given the legal and administrative requirements associated with Proposition 10 monies, it is advised that commissions designated as county departments establish their accounts using the special revenue fund designation.

### **4.3.3. Modified Accrual Basis of Accounting**

There are three bases of accounting: cash accounting, accrual accounting, and modified accrual accounting. Commissions should use the modified accrual method of accounting because it more effectively recognizes increases and decreases in financial resources.

The modified accrual basis of accounting is a method of accounting in which expenditures are recorded at the time liabilities are incurred and revenues are recorded when received in cash or are considered available for use. For example, under the modified accrual basis of accounting, local commissions would:

- Record tobacco tax allocations when actual disbursements are distributed from the state and received in the county treasurer's office.
- Record payments to providers for services provided under a contract at either the time an invoice is approved or at the time a check for services is disbursed.

### **4.3.4. Account Classification**

#### **4.3.4.1. Chart of Accounts**

Commissions engage in a wide range of financial activities. An account classification system called a chart of accounts is used to record and organize this financial activity. A well-organized chart of accounts provides the organizing framework for budgeting, and substantially enhances reporting capabilities. Each commission should adopt a standard chart of accounts along with an accompanying definition of each account.

A chart of accounts can be tailored to an organization's specific needs. In order to decide what to include in a chart of accounts, each of the following questions should be considered:



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- What reports do you want to prepare?
- What financial decisions, evaluations, and assessments do you need to make on a regular basis?
- What level of detail do you require?
- What is your capacity for tracking financial information?

The chart of accounts includes all accounts in the general ledger—assets, liabilities, fund balance, revenues, and expenditures. Asset, liability, and fund balance accounts reflect the financial resources of the commission and are referred to as balance sheet accounts. An excellent source for developing balance sheet accounts is Appendix E in GFOA's *GAAFR*.

Revenue and expenditure accounts reflect the operations of the commission and need to meet management's reporting needs. Below is a suggested list of revenue and expenditure accounts.

#### *General-Purpose Revenue Examples:*

- Tobacco Tax Revenue – Revenue received monthly from California Children & Family Commission based on birth-rate information and the commission's rules of distribution. Guidelines derived from Proposition 10 legislation.
- Interest Earnings – Revenue received from use of money over a period of time.
- State Surplus Monetary Investment Fund (SMIF) – Apportioned interest earned on tobacco tax revenue by the state prior to disbursement.
- Miscellaneous Revenue – Revenue not associated with specific state/county/city sources, such as registration fees for a conference held by a commission.

#### *Special Purpose Revenue Examples:*

- AmeriCorps Reimbursement Revenue – Revenue received from the federal government to reimburse AmeriCorps workers assigned to commission.
- State School Readiness Program – Grant revenue allocated from the State Commission to support local school readiness programs.
- Other Grants – Commissions may be awarded other grants from the state or other government or private agencies. Each grant's revenue should be reported separately.

Periodically, revenues are transferred to fund program activities from other financing sources. Below are examples of accounts used to make these transfers. Chapter 5, Financial Reporting, will provide more information on transferring funds.

#### *Transfers In:*

- Long-Term Commitment Account – Source of cash to augment commission funding from long-term commitment account as outlined in long-term financial strategic plan.
- Other – Source of funding from other outside source.

*Transfers Out:*

- Long-Term Commitment Account – Use of cash to fund long-term commitment account as outlined in long-term financial strategic plan.

*Program Expenditures:*

- Improved Family Functioning: Strong Families – Under this heading identify each program/project (summary format) that outlines the areas your local commission is focused on to achieve this outcome. Use the categorization you have used in your strategic plan.
- Improved Child Development: Children Learning and Ready for School – Under this heading identify each program/project (summary format) that outlines the areas your local commission is focused on to achieve this outcome. Use the categorization you have used in your strategic plan.
- Improved Child Health: Healthy Children – Under this heading identify each program/project (summary format) that outlines the areas your local commission is focused on to achieve this outcome. Use the categorization you have used in your strategic plan.
- Other long-range outcomes identified by local commission – Under this heading identify each program/project (summary format) that outlines the areas your local commission is focused on to achieve this outcome. Use the categorization you have used in your strategic plan.

Commissions will need to add to and delete from their chart of accounts based on their strategic plans, funding strategies, business plans, and external/internal reporting requirements. (Note: Refer to Appendix E in GFOA's *GAAFR* for additional examples.)

**4.3.4.2. Object of Expenditures**

In addition to developing a chart of accounts, government entities often code expenditure information to identify the “character” or “object” of the expenditure. It is recommended that each commission use eight major object classifications for services or commodities, with subcategories as needed (e.g., travel and meetings). Potential subcategories are provided in Appendix E in GFOA's *GAAFR*.

- Personal services – salaries and wages
- Personal services – employee benefits
- Purchased professional and technical services
- Purchased property services
- Other purchased services
- Supplies

- Property
- Other goods and services

#### 4.3.5. Program Accounting

Account classification creates a structure to account for assets, liabilities, fund balance, revenues, and expenditures. In addition, commissions often need information on programs. A program is a set of specific activities taken on by the commission to accomplish a particular purpose. Program activities may have more than one revenue source, and may require expenses from multiple organizational units. The crosscutting nature of program revenues and expenditures requires commissions to take added steps to collect and store information by program.

To establish program accounting, some organizations create transaction codes to capture program activity, while others create additional accounts. In cases where county accounting services are used, the county may have transaction codes or accounts to collect program (or project) information. In other cases, commissions may have to develop program accounting information in their internal accounting systems. For example, in Yolo County, School Readiness Initiative program costs are paid partly out of the county share of tobacco tax revenues and partly from State Commission matching funds, so the same program code (SRIPRO) has been set up for use in each of two different organizational units. Pure administrative costs, not directly attributable to a program, are charged to program code CFCADM. Funds that have not yet been committed through commission decision to any specific purpose are coded to program code UNCM00.

Because of the commission's legal mandate for outcome-based accountability, and the program evaluation requirements associated with the grant funds, commissions are encouraged to employ program accounting.

#### 4.3.6. Cost (Expense) Allocation

Most of the accounting for commission activities is accomplished directly by processing transactions. Transactions are coded and charged to designated fund accounts and programs. However, certain situations require special allocation steps to accurately account and report the cost of commission activities.

Cost items that comport to the commission's definition of administrative costs are charged directly to an administrative area in the accounting system. During the year, however, it may be necessary to apply these administrative costs to specific programs to determine "total" program costs. Also, during the year some costs will occur that have both a program and an administrative component, and other costs may involve more than one program. Cost allocation is used when costs need to be estimated and apportioned among different programs or organizational units. Examples of costs that may need to be allocated include office rent, telephone, and personnel costs.

Once it is determined that costs need to be allocated or apportioned, an allocation formula is created to obtain a reasonable estimate. State and local governments receiving large federal grants generally are required to maintain formal cost allocation plans. Specific guidance on cost allocation plans can be found in OMB Circular A-87. However, the cost of maintaining a formal cost allocation plan is

prohibitive for smaller government entities. It is recommended that local commissions use the cost categories described in Section 4.3.4.

For example, assume a three-person administrative staff had annual rental costs of \$12,000, personnel and benefit costs of \$150,000, commodity costs of \$8,000, and telephone costs of \$10,000. During the year the three-person staff maintained time records that showed administrative services were provided to five separate programs as shown below. Total administrative costs of \$180,000 would be allocated to each program as shown below:

Program	Total Admin Hours	% of Hours	Allocated Costs
1	1,000	20	\$ 36,000
2	2,000	40	72,000
3	500	10	18,000
4	500	10	18,000
5	1,000	20	36,000
<b>Total</b>	<b>5,000</b>	<b>100</b>	<b>\$180,000</b>

Where a commission does not use an ongoing time system, time studies can be conducted. At least once a year, the Yolo commission conducts a time study of all staff positions in order to properly compute expenses that can be submitted for reimbursement under the Medi-Cal Administrative Activities (MAA) federal entitlement program. The time study shows the percentage of each staff position's time that is spent on each commission program and on internal administrative activities. The results of this MAA time study are also used for internal allocation of costs across program codes. This leverages an established process while employing a standardized and consistent methodology.

### 4.3.7. Budgetary Control

The adopted budget approved by the commission (including amendments) creates a formal revenue and expenditure plan. As described in Chapter 3, *Planning and Budgeting*, staff administer and monitor the adopted budget during the year to establish budgetary control. Specific steps need to be taken to establish that control.

Initially, the budget needs to be aligned with the accounting system. The budget includes estimated allocations to the various program components that support the commission's goals for early childhood development. The program accounting structure needs to be aligned with the programs in the budget. Also, the revenue and expenditure items in the budget need to be aligned with the chart of accounts to effectively compare "actual" revenues and expenditures with "budgeted" revenues and expenditures.

Second, an encumbrance system is needed to control the expenditure side of the budget. Encumbrances represent the estimated amount of future expenditures that will result when unperformed contracts are completed. Essentially the encumbrance reserves a portion of a budget. When the contract is performed, an expenditure will be recorded in the accounting system (and the encumbrance will be reversed). Until the expenditure is recorded encumbrances are used so the commission does not over commit funds. Following are examples of where encumbrances are used:

- When a purchase order, contract, or other commitment is made and the goods

or services have not been received.

- Funds may be encumbered for estimated expenditures, such as utilities, for which no purchase document is issued.

Third, a monthly reporting system is used to identify budgeted and actual amounts and the fund balance, ensure resources are used for the appropriate purposes, and ensure resources are not expended too quickly. Chapter 5, *Financial Reporting*, discusses the monthly reporting system.

Fourth, during the year amendments are made to the original budget as circumstances change. Records of the original budget and all amendments need to be maintained. At year-end both the “original” budget and “final amended” budget amounts will be needed for financial reporting purposes.

## 4.4. SPECIFIC ACCOUNTING PROCEDURES

The following accounting procedures provide guidance for particular asset, liability, revenue, and expenditure/expense accounts. In many cases, the guidance presented focuses on procedures to safeguard financial resources. The examples of procedures provided illustrate steps that can be taken to establish internal control. In practice commissions may use other procedures to establish internal control.

### 4.4.1. Cash

Part of the overall maintenance of adequate accounting procedures is the ability to control cash collections and disbursements. Account procedures for cash should emphasize timely processing and recording. Specific procedures include:

- Segregation of duties in the cash collection and disbursements process, to the greatest extent possible;
- Review by check signers and approvers of supporting documentation for all disbursements;
- All cash collections, whether in the form of checks or currency, deposited in a timely manner, safeguarded until properly deposited, and accurately recorded in the accounting records;
- Restrictive endorsement of checks upon receipt;
- Bank reconciliations performed on a timely basis and reviewed on a timely basis by individuals not involved in the cash collection or disbursement process;
- Investigation of variances between bank statements and commission records;
- Cash and checkbooks secured with as limited access as possible;
- Disbursements, whether in the form of checks, electronic transfers, or other means, approved, adequately documented, and accurately recorded in the accounting records; maintenance of a process for retaining and retrieving sup-

porting disbursements documentation;

- Authorization and recording of account transfers required for wire transfers.

#### **4.4.2. Petty Cash**

Petty cash funds facilitate the purchase of goods and services under limited circumstances. Detailed procedures are needed to account for and safeguard petty cash, such as:

- Dollar limits established for petty cash funds;
- Funds kept in a locked location;
- Receipts required for all disbursements;
- Periodic surprise cash counts performed by supervisors;
- Petty cash custodian independent of the approval and accounting functions;

Custodians required to take uninterrupted (e.g., one week at a time) vacation every year;

- Identification of allowable and unallowable use of the petty cash fund;
- Establishment of reconciliation procedures, with reconciliation performed by someone other than the custodian;
- Replenishment of fund as needed by processing a request for payment form with attached paid receipts.

#### **4.4.3. Accounts Receivable**

An accounts receivables process will be maintained that identifies and bills all amounts due on a timely basis. The process will identify overdue receivables and provide timely collection notices. Specific procedures include:

- Creation of procedures to prepare and send billings in a timely manner;
- Approval of billing information, including rates and amounts;
- Daily deposit of collections;
- Billing, collection, and cash application performed by different people;
- Effective steps take to collect past due accounts, with uncollectible accounts written off after a certain period of time;
- Approvals required to write off accounts.

#### **4.4.4. Investments (Trust Fund)**

Financial information on effective managing of commission investments can be found in Chapter 2, Investment Management. From an accounting standpoint:

- Investments should be properly authorized and accurately recorded;
- Investments should be properly safeguarded;
- Sales of investments should be properly authorized and accurately recorded;
- Rate of return on investments should be appropriate and effective.

#### **4.4.5. Capital Assets**

Capital assets include such items as land, structures and improvements, furniture, and equipment owned by the commission. Under the modified accrual basis of accounting, commissions charge capital asset purchases as expenditures. Procedures to safeguard and control capital assets are as follows:

- All capital assets having a value of more than a specified dollar amount and a useful life of one year or more monitored through inventory controls;
- Management and commissioner approval of all capital asset purchases, depending on dollar amount;
- Pertinent data on capital assets (including description, cost, source of funds, and data acquired) recorded as soon as capital assets are acquired and data is available;
- All items tagged with a pre-numbered identification sticker;
- Performance of periodic physical inventories;
- Maintenance of a listing of expendable equipment (assets that do not meet the specified dollar amount to be classified as a capital asset, but require control) that could easily be misappropriated, as well as a periodic inventory of this equipment;
- Recording of donated capital assets at fair market value as of date of donation.

#### **4.4.6. Purchasing and Payables**

A purchasing process shall provide for the efficient purchasing of commission needs, prevent unnecessary purchase of materials and supplies, and provide compliance with budgetary requirements. The authorization to purchase supplies and services should be reflected in the accounting records and should include the following:

- Compliance with requirements for formal or informal bids;
- Approval of purchase orders based on available budget;
- Expenditures consistent with the purpose of the organization and the approved

strategic plan (California Codes, Health and Safety Code, Section 130100-130155);

- Establishment of purchase prices, terms, and commitments;
- Requisitioning of supplies and services;
- Recording of purchases in the correct time period and amount with sufficient documentation.

All expenditures made should be reflected in the accounting records—including the payment amount and allocation—in the correct time period, to the appropriate fund or account, and with sufficient information to identify the payee.

A complete accounts payable ledger should be maintained that shows liabilities to be paid in the future, when each one is due, and whether it has been paid. The following safeguards should be put in place:

- Review of invoices for calculation accuracy and payment approval;
- Comparison of invoice quantities, prices, and terms with purchase orders;
- Comparison of invoice quantities with receiving report.

#### **4.4.7. Payroll**

The payroll accounting procedure needs to ensure that paychecks are issued to employees on time and are accurate. All payroll liabilities should be reflected in the accounting records, including 1) the amount of the liability and 2) allocation to the appropriate fund, program, or expenditure account and time period. All recorded liabilities should be supported by appropriate evidence showing that the liability is for authorized work actually performed by authorized employees, temporaries, or consultants. Procedures to ensure reliable payroll accounting include:

- Time cards prepared and signed by employees and approval by the supervisor and executive director prior to payroll preparation;
- Proper documentation of changes in salaries and wages in the personnel file;
- Payroll and benefit calculations and eligibility for benefits verified periodically.

#### **4.4.8. Compensated Absences**

Compensated absences are absences for which employees will be paid, such as vacation and sick leave. A liability for compensated absences for services already rendered and that are not contingent on a specific event should be accrued as employees earn the rights to the benefits. The compensated absence liability should be calculated based on the pay or salary rates in effect at the balance sheet date.

#### **4.4.9. Construction Costs**

Construction projects may be funded based on the completed contract method and invoices submitted by the contractor. An initial advance payment may be issued.

#### **4.4.10. Leases**

Leases entered into by the commission are classified as capital leases or operating leases. Leases that represent substantially the entire benefits and risks incident to ownership of the property, such as a capital lease, are accounted for as the acquisition of an asset and the incurrence of an obligation. Other types of leases should be classified as operating leases.

#### **4.4.11. Travel and Business Expense**

Commissioners and staff are authorized to receive reimbursement for travel and business expenses incurred while attending official functions, as long as the expenses are reasonable, prudent, and appropriate. Reimbursement for expenses associated with other related training, seminars, or meetings must have prior approval from the executive director, in the case of commission staff, or the commission chair, in the case of commissioners.

#### **4.4.12. Grant Accounting**

Most commission funds come from distributions of the tobacco tax revenues collected by the state. However, commissions receive grant funds from the State of California and other sources. Grant funds normally are restrictive in how the funds may be used, and require special accounting information be collected and reported periodically. Commissions that do not fund capital assets and matching funds from the State Commission should not be used for these purchases. Procedures needed to record and safeguard grant funds include:

- A grant budget or plan is prepared when a grant is established, including restrictions and parameters of the grant. Account numbers are created to track funding and expenses in accordance with the grant.
- Procedures are established for receipts to be recorded accurately, deposited in a timely manner, and where appropriate, allocated to the correct account.
- Projects with matching fund requirements are tracked in a manner that allows verification that the matching fund requirements have been met. Certain State Commission grant funds carry restrictions requiring the local commission to match the state grant funds with local funds according to a pre-defined ratio, such as one local dollar for every state dollar or three local dollars for every state dollar. Matching fund requirements also occur with federal grants, and can also be found in grant agreements for private foundations.

Commissions should use the accounting procedure that works best for tracking matching funds. For example, in Yolo County, if three local dollars must be used for every state dollar, the transaction would be coded to allocate 75 percent of the expense amount to the cost center corresponding to the source(s) of local funding being used as the match and 25 percent of the expense amount to the cost center

holding the funds with the matching fund requirement.

- A review procedure is used to review grant expenditures to ensure they meet grant requirements, in addition to meeting the purposes of the commission as expressed in the strategic plan.
- A review procedure is used to ensure payroll costs charged to grants are based on only the time spent working on grant programs.
- Periodic reviews are conducted to determine that audit requirements are met and follow-up is performed on audit recommendations.
- Periodic management reports are generated to analyze compliance with matching fund requirements.

#### **4.5. RESOURCES**

- *Governmental Accounting, Auditing, and Financial Reporting* (Available through GFOA's online publications catalog)

## CHAPTER 5: FINANCIAL REPORTING

### 5.1. INTRODUCTION

This chapter provides First 5 commissions with recommended policies and procedures for reporting financial information. It should be read and applied in conjunction with the chapter on accounting in order to ensure consistency between these two related areas. This chapter focuses primarily on financial information; however, it also includes information on reporting on achievement of program or strategic goals, including output and outcome information because of the important link between financial reporting and goal achievement.

First 5 commissions are responsible for two kinds of reporting: external and internal. While independent commissions will prepare GAAP statements at the end of the fiscal year, commissions that are agencies of county governments will be part of the county's GAAP financial statements at the end of the year. However, for management purposes, all commissions should provide internal reports on a monthly basis.

#### 5.1.1. Legal Requirements

California law requires that the state and local commissions adhere to specific reporting requirements (California Codes Health and Safety Code Sections 130100-130155).

*County Commission Reporting.* On or before October 15 of each year, the State Commission and each county commission shall conduct an audit of, and issue a written report on, the implementation and performance of their respective functions during the preceding fiscal year. At a minimum, this report should include which funds were expended, the progress toward and the achievement of program goals and objectives, and the measurement of specific outcomes through appropriate indicators (Section 130150).

The county commission shall conduct at least one public hearing prior to adopting any annual audit and report (Section 130140 (G)).

Each county commission shall make copies of its annual audits and reports available to members of the general public on request and at no cost (Section 130150 (d)).

The audits and reports of each county commission shall be transmitted to the State Commission (Section 130150 (a)).

*County Commission Reporting of State Commission Information.* The State Commission shall make copies of each of its annual audits and reports available to members of the general public on request and at no cost. The State Commission shall furnish each county commission with copies of those documents in a number sufficient for local distribution by the county commission to members of the general public on request and at no cost (Section 130150 (c)).

The county commission conducts at least one public hearing on each annual report by the State Commission prepared pursuant to subdivision (b) of Section 130150 (Section 130140 (H)).

### 5.1.2. Best Practices

Best practices in financial reporting for local government have been established and maintained by the Governmental Accounting Standards Board (GASB) and the Governmental Finance Officers Association (GFOA). The GASB provides a formal standard setting process for annual financial reports, using statements and other technical pronouncements to continually improve reporting practices. GFOA provides guidelines for reporting excellence and administers an awards program to recognize effective financial reporting by state and local governments. The criteria used in this program have become the benchmark for government reporting.

## 5.2. POLICY STATEMENT

Commissions will report financial information to supply the appropriate individuals the right information, at the proper time, and in the correct format. Specifically, management will take steps to achieve the following goals identified by GFOA for external and internal reports:

- *Content* – financial reports balance competing demands for completeness and conciseness.
- *Timeliness* – information is received soon enough to take effective action.
- *Currency* – the information communicated is current.
- *Accuracy* – the information is reliable (not necessarily precise).
- *Access* – the information is accessible to those who need it.

Annual financial statements will be prepared in accordance with generally accepted accounting principles (GAAP). Likewise, annual financial statements will be independently audited in accordance with generally accepted government auditing standards (GAGAS).

Independent commissions will issue comprehensive annual financial reports (CAFRs) that include the required financial statements and appropriate introductory, supplemental, and statistical information. Although all commissions are required to conduct an annual audit, those that are county government agencies or component units are not required to issue CAFRs as such detailed financial information is reported in the county government's comprehensive report. However such commissions are encouraged to do so.

## 5.3. PROCEDURES

### 5.3.1. External Reporting

External reporting refers to the annual public distribution of “general-purpose” financial statements designed to meet the basic financial information needs of a variety of potential users, including taxpayers and citizens, oversight and legislative bodies, and investors and creditors. The goal of external reporting is to provide the information needed by interested parties to gain a fair understanding of the government’s financial position and results of operations. External reports are

developed in conformity with GAAP. GAAP requirements are designed to provide all primary users of general-purpose external financial reports with the reliable information needed to assess an entity's finances.

External reporting is a fundamental responsibility of all governments. This section describes two types of external reports local commissions need to provide—the comprehensive annual financial report, or CAFR, and the popular report. Independent commissions typically prepare both a CAFR and a popular report, while county agency commissions often prepare just the popular report.

The CAFR is an extensive financial disclosure of the commission's use of funds for the year, financial performance, and the financial position at year-end. Budget information, government fund information, and government-wide information is presented. The comprehensive nature of the CAFR has evolved over time as the dimension of public disclosure has increased. Credit rating agencies, government financial analysts and other government officials are the principal users of the CAFR. The popular report is a new external report that summarizes the information in the CAFR and provides more subjective information about the governmental entity and the surrounding region. It has been crafted to better communicate with the citizenry.

#### **5.3.1.1. Comprehensive Annual Financial Report (CAFR)**

Commissions will need to produce a CAFR in accordance with applicable requirements and best practice standards in order to meet the expectations of their stakeholders. The CAFR opens with an Introductory Section to orient the user to the document, as well as the governmental entity. The Financial Section provides the basic financial statements and detailed supplemental data. The Statistical Section provides relevant statistical data. Following is a discussion of each section, including examples of significant documentation requirements. To obtain a complete checklist for the CAFR, visit [http://www.gfoa.org/forms/documents/gpqu040204\\_000.doc](http://www.gfoa.org/forms/documents/gpqu040204_000.doc).

##### **5.3.1.1.1. Introductory Section**

This section of the CAFR, generally excluded from the independent audit, orients and guides the reader through the report. The introductory section generally includes:

- *Cover, Table of Contents, and Formatting.* General information about the name of the government, preparers' names, a description of the three sections of the CAFR (Introductory, Financial, Statistical), the table of contents, and other explanatory information.
- *Letter of Transmittal.* This is a very important document designed to communicate the CAFR to the users. The letter is a chance to bring the readers attention to key topics included in CAFR, including legal requirements, management's framework of internal control, independent audit, and single audit. It also directs attention to Management's Discussion and Analysis (MD&A) in the Financial Section.

The letter of transmittal is often used to provide information useful for assessing

the commission's financial position, as well as information about the commission itself, such as key officials and an organization chart.

#### **5.3.1.1.2. Financial Section**

The financial section of the CAFR presents the basic financial statements of the commission, preceded by the independent auditors' report and the MD&A. Basic financial statements include the government-wide financial statements, fund financial statements, and the related note disclosures. In addition to the basic financial statements, note disclosures, and the MD&A, the financial section includes detailed financial data and other applicable required supplementary information (RSI).

- *Independent Auditors Report.* This is the first document presented in the Financial Section. The Independent Auditors Report needs to express an opinion on fair presentation of the basic financial statements in conformity with GAAP, and indicate that the audit was conducted in conformity with generally accepted government auditing standards.
- *Management's Discussion and Analysis (MD&A).* The MD&A precedes the basic financial statements and provides a brief, objective, and clear introduction to these financial statements, including an analysis of financial performance for the year and the financial position at the end of the year. The analysis is based on facts, decisions, and conditions and addresses whether the government's overall financial position has improved or deteriorated during the reporting period. The government should disclose any other "currently known facts, conditions, or decisions" that are expected to have a significant effect on financial position (net assets) or results of operations (revenues, expenses, and other changes in net assets).

If economic factors significantly affected the operating results of the current period, they should be discussed as part of this analysis. Significant budgetary variations (both original budget versus final amended budget and final amended budget versus actual) for the general fund are also discussed.

Restrictions, commitments, or other limitations significantly affecting the availability of fund resources for future use are also included. Discussion of "possible" future events should not be included in the MD&A, but rather is appropriate for the Letter of Transmittal.

The MD&A describes the basic government-wide financial statements and the basic fund financial statements, as well as the difference in the kinds of information provided by each. Condensed financial data, extracted from the government-wide financial statements, is included in the MD&A:

- Total assets (distinguishing between capital and other assets)
- Total liabilities (distinguishing between long-term liabilities and other liabilities)
- Total net assets (distinguishing invested in capital assets [net of related debt]; restricted net assets; and unrestricted net assets)

- Program revenues (by major source)
  - General revenues (by major source)
  - Total revenues
  - Program expenses (at least by function)
  - Total expenses
  - Excess or deficiency (before any contributions to term and permanent endowments, contributions to permanent fund principal, special items, extraordinary items, and transfers)
  - Contributions
  - Special and extraordinary items
  - Transfers
  - Change in net assets
  - Ending net assets
- *Financial Statements.* The financial statements of the commission include fund (general fund, special revenue) financial statements and government-wide financial statements prepared in accordance with GAAP, and notes to the financial statements. The fund financial statements are prepared on the modified accrual basis, the basis of accounting recommended in Chapter 4, *Accounting*. That information will need to be converted to a full accrual basis to prepare government-wide financial statements.
- There are two financial statements required for government funds (including special revenue funds established for county-agency commissions):
- 1) balance sheet and
  - 2) statement of revenues, expenditures, and changes in fund balance.
- There are two financial statements required for government-wide reporting (the reporting used by independent commissions):
- 1) statement of net assets and
  - 2) statement of activities.
- *Required Supplementary Information (RSI).* RSI is required information that is reported in addition to the basic financial statements. RSI includes the MD&A which was discussed earlier. The other major RSI that commissions need to provide is the budgetary comparison schedule.

Budgetary comparison schedules are needed for the General Fund and major Special Revenue Funds. The schedule needs to include the adopted budget, the final budget, and the actual results. Actual results need to be presented on the same accounting basis as the budget. If the budget is not based on modified accrual accounting, the commission will need to reconcile the two different accounting bases in a separate schedule or note to the RSI.

It should be noted that much, if not all, of a commission's internal reporting will be consistent with the budgetary basis which is not in accordance with GAAP. Reporting in accordance with GAAP is primarily for the benefit of outside users of the financial statements, whereas internal reporting focuses its attention on management, elected officials, and others primarily interested in the flow of financial resources and compliance reporting. It is recommended that commissions place equal emphasis on external and internal reporting.

#### **5.3.1.1.3. Statistical Section**

The statistical section provides financial and statistical data that better informs the user about the commission's activities. Trend data is provided, where available, for 10-year periods. Following are the required statistical section categories generally related to commission activities. Commissions can provide other historical trend data as they deem appropriate.

- Financial trends information
- Revenue capacity information (primary revenue sources)
- Demographic and economic information
- Operating information

#### **5.3.1.1.4. Audit Requirements**

All commissions are required to conduct an independent audit of the basic financial statements. For commissions receiving federal financial assistance, possibly from several different federal grantor agencies, the Single Audit Act allows a single audit to meet the needs of all federal grantor agencies. This single audit can be performed by the commission's external financial auditor, if contracted for, or by another third-party auditor (see Single Audit discussion below).

The audit requirements refer to an external review required by an independent audit firm to determine that the financial statements fairly present the financial position of the agency being audited in accordance with GAAP. Auditors make this determination based on a review and testing of financial data maintained by the commission. In general, there are two types of opinions that auditors can make after review of the financial information:

- An unqualified or "clean" opinion is one in which the auditor can state without reservation that the financial statements are fairly presented in conformity with GAAP.
- A "qualified" opinion is one in which the auditor expresses reservations about the fair presentation of the financial statements in conformity with GAAP. A common reason for a qualified opinion may be that the data provided is insufficient to support the information provided in the financial statements.

Particular audit requirements include:

- *Internal Controls.* It is recommended that commissions include within the

scope of the financial audit a review of internal controls. It is a common practice for auditors to issue a report on the internal controls tested as part of the financial statement audit. A review of internal controls will consider issues such as segregation of duties, existence of regular reporting processes, and internal mechanisms to prevent and detect instances of noncompliance or, in extreme cases, negligence or fraud. As instances are identified, these issues should be brought to the attention of management and the commission.

- *Management Letter.* The most common forum for auditors to communicate all reportable conditions is known as the management letter. The management letter provides a vehicle for the auditor to share concerns or other issues identified and to recommend appropriate management corrective action. Auditors may express concerns in the management letter that are not materially significant enough to result in a change in the opinion. Commissions and the fiscal officer/director should document and monitor the actions that will be taken during the next fiscal year in response to the concerns/comments outlined in the management letter.
- *Single Audit.* The provisions of the Single Audit Act apply to any commission that expends \$500,000 or more per fiscal year in federal awards. Expenditures include expenditure/expense transactions associated with grants, cost reimbursement contracts, and cooperative agreements and direct appropriations. They also include amounts disbursed to sub-recipients (pass-through grants), the use of loan proceeds under loan and loan-guarantee programs, the receipt of property, the receipt of surplus property, the receipt or use of program income, the distribution or consumption of food commodities, the disbursement of amounts entitling an entity to an interest subsidy, and insurance (during the award period).

The fundamental standards of financial audits in the public and private sectors are provided by *generally accepted auditing standards* (GAAS) established by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA). The ASB has issued a formal Statement of Auditing Standards (SASs) that establishes basic auditing standards. In the public sector, there is a second set of standards that commonly guides financial audits. These standards are set by the Comptroller General of the United States and are found in the General Accounting Office (GAO) publication, *Government Auditing Standards*, or the Yellow Book as it is commonly known. The terms *generally accepted government auditing standards* (GAGAS) or *government auditing standards* (GAS) are commonly used to describe these standards.

- *Acceptance of Annual Financial Audit.* The commission reviews the annual independent audit report, including discussion of reportable conditions, internal controls and management points. After review, the commission approves and accepts the independent audit, identifying specific appropriate corrective actions to any financial or management risks noted in the audit.

#### **5.3.1.1.5. Public Participation**

The commission is required to have an annual audit pursuant to Section 130150 of the Health and Safety Code. A public hearing must be held to present the annu-

al audit as well as the annual report to the California Children and Families Commission. The annual audit and report must be submitted to the State Commission by October 15 of each year.

The State Commission prepares a written report that summarizes and consolidates the annual audits and reports of all the county commissions for the preceding year. This report is submitted to the governor, the legislature, and each county commission.

#### **5.3.1.1.6. Popular Report**

In recent years governments have begun issuing financial reports that more effectively communicate financial information to the user. This summary report, referred to as a popular report, is less technical and less complex, but provides reliable information. Popular reports use the audited information from the CAFR, as well as other relevant data about the commission.

All commissions are encouraged to issue popular reports. The greatest benefit of issuing a popular report is the ability to effectively communicate with stakeholders concerning the performance of the commission. Many stakeholders who do not have extensive government finance experience will find the popular report format more useful than the CAFR.

### **5.3.2. Internal Reporting**

This section provides recommendations for an internal reporting framework. This section does not represent reporting in accordance with GAAP, but rather reporting in accordance with budgeting processes. As was noted earlier, external financial reports that follow GAAP generally have a different look and focus than the internal reports. Internal reporting typically is designed to accomplish two goals:

- 1) allows management to monitor compliance with legal and contractual provisions applicable to the management of public funds; and
- 2) provides management with the information on current performance that it needs to make future financial plans.

Because internal reports are designed to serve the needs of management, management is free to select the format and content it believes is most relevant, with timeliness being a key consideration for their use as monitoring or planning documents. Again, it is recommended that commissions place equal emphasis on external and internal financial reports and recognize that each has a different user base.

#### **5.3.2.1. Balance Sheet**

Public sector entities typically produce balance sheets only at year-end, with the exception of reporting for enterprise funds and other business-type operations. However, commissions may choose to produce monthly or quarterly balance sheets. If commissions decide to include balance sheets as part of their internal reporting, they should include the following:

- *Assets*. Assets should include cash, receivables, and amounts due from other

funds or county agencies.

- *Liabilities.* Liabilities should include accounts payable, accrued liabilities, and amounts due to other funds or county agencies.
- *Fund balance.* The fund balance category is of particular importance for First 5 commissions given the long-term perspective under which they operate. Fund balance includes funds committed for multi-year initiatives and programs. Proper reporting for fund balance provides an opportunity for commissions to report on how they have committed funds over a period of years. Effectively accounting for fund balances involves recognizing major organizational decisions concerning the future use of funds, with varying levels of obligation. A consistent application of the methods for committing funds is essential.

A commission may want to report on fund balance during the fiscal year or only at year-end. Note that for GAAP reporting in the Comprehensive Annual Financial Report, fund balance is reported within the balance sheet in *governmental funds* financial statements—for example, the general fund and special revenue funds. In the *government-wide* section of the CAFR, the difference between assets and liabilities is reported as *net assets*. These reporting requirements conform to GASB 34 model. Independent local commissions should refer to GFOA's *GAAFR* for guidance on reporting net assets compared to reporting fund balance.

Fund balance represents the value of the funds available to the commission. Fund balance is broken down into two categories, reserved and unreserved. Each category has several components, all of which are described below.

#### **5.3.2.1.1. Reserved Fund Balance**

Reserved fund balance represents the portion of the fund balance restricted by law or legally obligated to outside parties. There are four components to this category—reserved for encumbrances, reserved for obligations, reserved funds not yet obligated, and reserved for First 5 California initiatives. Each of these components is described below.

- *Reserved for encumbrances.* Reserved for encumbrances should be recognized as reserved fund balance. The key defining concept of an encumbrance is that it is a legal obligation of a commission based on an executed contractual agreement. Examples of reserved for encumbrances include, but are not limited to:
  - Future payments due to providers of services to children and families
  - Future payments due on professional services contracts
  - Future payments due under lease arrangements

In all cases, amounts can only be classified as reserved for encumbrances in the CAFR if (a) there is a fully executed written contract or purchase order detailing the obligations, (b) the payment obligation is not due in the current period,

and (c) it is probable or expected that future expenditures will be made in accordance with the contract terms. The latter provision means that if it is reasonably likely that a contract will be amended or terminated before all scheduled payments are made, the encumbrance must be limited to the total amount of payments that are expected to actually be incurred (if less than the full contract value).

If the commission, or the county within which a commission operates as a county agency, has a policy of recording encumbrances at the time a purchase order is created, the value of all outstanding purchase orders and contracts (where no invoice has been received for payment) for future periods would be included in the reserved for encumbrances component.

- *Reserved for obligations.* This category covers situations in which the commission has explicitly authorized and directed staff to enter into an agreement with a specified agency, but the contract has not actually been executed. For example, if the commission has approved four new grants totaling \$200,000 to specific organizations for specific projects or services but contracts have not been completed and signed, the grants should be shown in the CAFR as reserved fund balance under this item.

In order to be categorized as reserved for obligations, funds must meet the following requirements: (a) formal action to approve the grant(s) and contract(s) must have been taken by the commission and reflected in the public meeting minutes, and (b) the grant(s) and contract(s) must not have been executed yet, thereby avoiding any double-counting with the reserved for encumbrances line.

- *Reserved funds not yet obligated.* Funds that have been received by the commission from sources other than the county pro rate share of tobacco tax revenues and that contain restrictions imposed by the funding source regarding how the money can be used, by definition, are committed to the purpose designated by the funding source. Examples that fall into this category include but are not limited to:
  - Money received from the State Commission for specific programs or initiatives, such as school readiness or child care provider retention incentive funds, that must be used exclusively for the purpose designated by the State Commission.
  - Grants received from private foundations that contain restrictions in the grant agreement regarding how the funds may be used.

This component should only include restricted funds that have been received but not yet authorized by the commission for release through a contract or purchase order. Care must be taken to avoid any double counting between amounts on this line and amounts included in the previous two components.

Administrative augmentation and minimum allocation funds provided by the State Commission to smaller-budget counties should not be included. These funds do not contain mandated restrictions and are able to be used flexibly by the commission.

- *Reserved for First 5 California initiatives.* Several State Commission initiatives require participating counties to guarantee a matching investment from the county commission. The total future amount that the county commission must reserve in order to meet its matching guarantee should be treated as committed funds.

Amounts shown on this line item must meet the following criteria: (a) a local cash match is required in order to participate in a program sponsored by the State Commission; (b) a written plan has been approved by the State Commission that describes the program/services to be conducted and contains a budget showing how money is expected to be spent; and (c) specific annual dollar amounts of local cash match coming from the county commission rather than other sources are shown in the written plan. The amount should include all future years that are explicitly covered by the plan and budget approved by the State Commission, but not additional years beyond what has been formally approved.

#### **5.3.2.1.2. Unreserved Fund Balance**

Unreserved fund balance represents funds that can be spent at the discretion of the commission. Unreserved fund balance contains two components: designated and unreserved undesignated. Each is described below.

- *Designated for Local Initiatives and Program Sustainability.* Funds are appropriately included in this component if they fall under one of two types:
  1. Funds to operate a specific program or project in the current or future fiscal years that have not yet been encumbered or authorized for definite contracts, where all of the following criteria are met:
    - A written plan has been developed describing the program or project and the time period covered by the plan.
    - The plan contains a detailed budget or expenditure plan showing the amount of funds expected to be expended and the nature of the expenditures for each fiscal year covered by the plan.
    - The commission has formally approved the plan and budget in a public meeting, as documented in the meeting minutes.
    - The commission certifies that it intends, to the best of its ability, to expend the funds in accordance with the plan and budget.
  2. Funds that have been set aside for long-term program sustainability, where all of the following criteria are met:
    - A long-range financial plan has been prepared that shows the specific dollar amounts that must be reserved for program sustainability in each of the early years of the plan, the timing for when sustainability funds will start to be drawn down, and the nature of the expenditures that are envisioned in each year covered by the plan.

- The commission has formally approved the long-range financial plan in a public meeting, as documented in the meeting minutes.
- The commission certifies that it intends, to the best of its ability, to manage the sustainability fund in accordance with the provisions of the long-range financial plan.
- The commission has adopted its annual budget consistent with the assumptions and plans in the long-term financial plan.

When these criteria are met, the accumulated balance of the sustainability fund or account may be treated as unreserved designated fund balance.

Funds that do not meet all of the above criteria cannot be listed here as reserved or unreserved designated fund balance. For purposes of the CAFR, such funds would be included in unreserved undesignated fund balance, because there is still significant uncertainty regarding whether, or how, the funds will be expended.

- *Unreserved Undesignated.* This category includes the remainder of the fund balance: funds that either have not yet been allocated for a specific purpose or have been identified in only a general manner where the commission has significant flexibility in changing the amount or nature of the designation.

#### 5.3.2.2. Operating Statement

Each commission should provide a monthly statement of revenues and expenditures. At a minimum:

- Revenue should be classified by major sources: 1) general-purpose revenue, including tobacco tax revenue, interest earnings, and miscellaneous revenue; 2) special-purpose revenue (e.g., state school readiness program revenue); and 3) other sources (e.g., transfers from the long-term commitments account).
- Expenditure items should be classified by major category, such as personal services, supplies, and equipment. County-agency commissions are usually reliant on the county auditor-controller's office for financial reports. As long as these reports are presented in sufficient detail and in a format that enables commissioners and staff to understand their financial situation, the responsibility of the commission has been fulfilled. If standard county reporting formats are insufficient, commissions may need to request the creation of reports designed for their particular needs. Most modern automated financial systems are able to produce special reports.

#### 5.3.2.3. Performance Data

Each commission should report on services delivered to children and associated parties on a monthly basis.<sup>1</sup>

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<sup>1</sup> A workgroup made up of state and local commission staff has developed a revised evaluation framework that contains formats for commissions to report program and financial information in a standard and consistent manner to demonstrate accountability to external stakeholders. If approved by the State Commission, this new framework will not become effective until FY2007.

Statistical data pertaining to programs and services funded entirely by local commissions, school readiness, and other jointly funded programs should be reported in a format consistent with the management needs of the commission and, where possible, consistent with the format used to report information to the state for its annual report and as specified in the statewide evaluation framework.

#### **5.3.2.4. Frequency**

Operating results, including internal statements of expenses and revenues and program information, should be reported on a monthly basis. It is not necessary to produce a balance sheet on a monthly or quarterly basis, but commissions that desire this information should follow the guidelines above.

Internal reports should be regularly issued to each commission's management team for review and approval and with sufficient time for commissioners to review prior to presentation at commission meetings.

### **5.4. MODEL DOCUMENTS**

- Annual Financial Statement – Statement of Activities
- Annual Financial Statement – Balance Sheet
- Annual Financial Statement – Statement of Net Assets
- Annual Financial Statement – Statement of Revenues, Expenditures, and Changes in Fund Balance
- Internal Management Report – Monthly Balance Sheet
- Internal Management Report – Monthly Operating Statement
- Management's Discussion and Analysis
- Local Commission Internal Control Risk Assessment

### **5.5. RESOURCES**

- GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*
- *Governmental Accounting, Auditing, and Financial Reporting* (Available through GFOA's online publications catalog)

## CHAPTER 6: ADMINISTRATIVE COSTS

### 6.1. INTRODUCTION

Commissioners and other Proposition 10 stakeholders want to know not only that First 5 commissions are achieving results for California's children, but also that funds allocated to commissions are spent wisely and efficiently. Clearly defining administrative costs and establishing appropriate spending limits on such costs provides assurance to stakeholders that the maximum possible level of resources is spent on direct programs and services. This chapter establishes procedures for defining administrative costs and provides guidelines for commissions to use in setting spending limits on administrative activities.

It is important to understand the unique nature of First 5 commissions and the purpose of Proposition 10 in establishing administrative cost guidelines. A “one-size fits all” approach is not appropriate given the large variation in size, type (county agency or independent), and programming. Several factors, other than relative efficiency, affect the amount commissions spend on administrative functions. These factors are discussed below.

*First 5's high level of contracting for services and emphasis on evaluation.*

Enabling legislation and the structure of the First 5 initiative (for example, the level of contracting for services) distinguishes First 5 organizations from other governments, especially general-purpose governments. The level of effort devoted to planning, evaluation, and provider monitoring goes far beyond that of most general-purpose governments. In contrast to general-purpose governments that directly provide most services themselves, most commissions contract for almost all of their program activities (Alameda County is a notable exception to this generalization).

*Differing definitions of administrative costs.* Commissions may include different cost categories in their administrative costs, resulting in varying percentages of total expenditures being reported but no material differences in efficiency. For example, one commission may include the costs of all commission staff, while another may exclude the costs of staff that work entirely with a specific program.

*Allocation of support services.* Commissions may differ in the support services that are provided by their county government and how those costs are allocated to commissions.

*Provider issues.* Commissions may differ in the management capability of their service providers. A commission might have lower administrative costs because its providers require less technical assistance, or higher administrative costs because its providers have less administrative capacity. Thus, using a standard governmental guideline for administrative cost percentages as an indicator for efficiency could result in the limiting of awards to smaller or less administratively sophisticated providers, even though they might be able to produce excellent programmatic results.

*Economies of scale.* Smaller commissions, due to their smaller dollar allocations, typically have higher administrative cost percentages due to their inability to achieve the economies of scale available to larger commissions.

### 6.1.1. Best Practices and Standards

#### 1. GFOA Recommended Practice on Costing Government Services

The full cost of a service encompasses all direct and indirect costs related to that service. Direct costs include the salaries, wages, and benefits of employees while they are exclusively working on the delivery of the service, as well as the materials and supplies, and other associated operating costs such as utilities and rent, training, and travel. Likewise, they include costs that may not be fully funded in the current period such as compensated absences, interest expense, depreciation or a use allowance, and pensions. Indirect costs include shared administrative costs within the work unit and in one or more support functions outside the work unit (e.g., legal, finance, human resources, facilities, maintenance, technology). These shared costs should be apportioned by some systematic and rational allocation methodology and that methodology should be disclosed.

#### 2. United States Office of Management and Budget, Circular A-21 – *Cost Principles for Educational Institutions*

Departmental administrative costs are defined as expenses "...: which have been incurred for administrative and supporting services that benefit common and joint departmental activities. Departmental administrative costs are the costs of administrative and clerical salaries, office supplies, postage, local telephone costs, memberships, and other similar costs which support the basic missions of the university (instruction, research, and public services)."

#### 3. United States Office of Management and Budget, Circular A-87 – *Cost Principles for State, Local, and Indian Tribal Governments*

Administrative costs are referred to as "central services." Allocated central services refers to central services that benefit operating agencies but are not billed to the agencies on a fee-for-service or similar basis. These costs are allocated to benefited agencies on some reasonable basis. Examples of such services might include general accounting, personnel administration, purchasing, etc.

#### 4. California State Auditor's Office – 2004 Audit of First 5 Commissions

The state audit recommended that each commission define what constitutes administrative costs, set a limit on administrative costs, and then track expenditures against that limit.

## 6.2. POLICY STATEMENT

At minimum, each First 5 commission should adopt a written policy that defines administrative costs and sets an acceptable upper limit for administrative costs. First 5 commissions should not only separate program costs from administrative costs, but also should establish a third category—evaluation costs. Creating this third category distinguishes the costs for "overhead" activities from the costs for evaluation and reporting activities.

Below are definitions for the three cost categories referred to above.

- *Administrative costs.* Costs incurred in support of the general management and administration of a First 5 commission, for a common or joint purpose that benefits more than one cost objective<sup>1</sup> (other than evaluation activities), and/or those costs not readily assignable to a specifically benefited cost objective.
- *Program costs.* Costs incurred by First 5 commissions readily assignable to a program or service provider (other than for evaluation activities) and/or in the execution of direct service provision.
- *Evaluation costs.* Costs incurred by First 5 commissions in the evaluation of funded programs based upon their accountability framework and data collection and evaluation for required reporting to state and local stakeholders.

Commissions should adopt a “principles-based” approach to defining administrative costs and setting limits on such costs that incorporates the following principles:

1. Administrative costs are general in nature. This principle distinguishes between those costs that specifically and directly benefit a business unit, program, or evaluation activity from those that do not.
2. Administrative costs support a commission’s basic mission rather than specific program goals. This principle distinguishes between the nature of costs that provide direct value to achieving specific program goals and objectives from those that do not.
3. Evaluation costs pertain to those activities undertaken to support the collection, production, and presentation of evaluation information to the state and local stakeholders.

## 6.3. PROCEDURES

### 6.3.1. Policy Adoption

Each commission should adopt a policy statement that:

1. Defines administrative costs consistent with the above definition and requires adherence to this definition in its budgeting, accounting, and financial reporting processes.
2. Establishes an upper limit on administrative costs as a percentage of total costs, based on an analysis of its administrative spending needs and best practice in government finance.
3. Requires a periodic review of the validity of the adopted definition and percentage (based on changes in state law, regulation, county government

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<sup>1</sup> Cost objective is a function, contract, grant, or other activity requiring cost data and for which costs are incurred.

requirements, and other relevant factors).

4. Requires commission staff to report on administrative costs periodically during the year and as part of the commission's annual financial report.

Each commission will be responsible for ensuring compliance with the policy it sets. Procedures will be based on the following general parameters:

1. All costs fall into one of three major categories: administrative, programmatic, or evaluation. Figure 1 provides guidance on categorizing costs. Monitoring costs will be included in administrative costs unless those costs can be specifically associated with particular programs (for example, technical assistance to a service provider), in which case they may be included in program costs.
2. Commissions will make their own determinations of where each of their cost elements fall, using the definitions provided for each category. However, any costs that a commission assigns to program costs that would typically be considered administrative in nature will require clear, auditable justification. Guidance for defining cost items may be found in GFOA's *Governmental Accounting, Auditing, and Financial Reporting*, which describes and defines "objects of expenditure" in Appendix E. Another point of reference is Figure 1, which provides an example of how a commission may allocate costs.
3. Staff costs may be assigned to program costs, as long as that time is limited to actual time spent on program-specific activities and appropriate records are maintained for audit and review purposes. One individual's time may be divided into more than one category, as long as accurate records are maintained. Staff salaries and benefits may be charged to each of the three categories, reflective of the proportion of work activity performed in each.
4. Commission staff should use valid methodologies and tools for allocating costs. Valid methods include automated cost accounting systems, review of payroll records, cost finding (a method for estimating costs based on observation, review of records, and interviews with employees), time studies, or other industry standards. While larger commissions may have the resources to establish automated cost accounting systems, smaller commissions will likely need to use a less formal and less precise (but no less legitimate) approach such as cost finding.

### 6.3.2. Organizational Procedures and Accountability Mechanisms

As part of the broader application of this administrative cost guidance, commission staff will play an integral role in adopting and executing this recommended practice. These procedures are provided below.

- Commission staff will be responsible for establishing cost elements for each of the three categories: administrative, program, and evaluation (see Figure 1).
- Commission staff will conduct an initial analysis to determine and document an upper percentage limit for administrative costs. Analysis should include a review of historical costs and benchmarking against other similar organizations (other First 5 commissions of similar size and demographics or non-profit agencies serving similar populations, for example).

- Commission staff will establish within the accounting and reporting system a methodology for tracking and reporting on program, administrative, and evaluation costs.
- During budget preparation, commission staff will provide information on estimated costs to be included in the three categories of program, administrative, and evaluation.
- Commissions will be individually responsible for maintaining auditable records to ensure compliance with their administrative cost policy.
- Commissions should provide information on administrative and evaluation costs in reports that go to the public (budgets, annual financial reports, community status reports) and use these reports to educate stakeholders, oversight bodies, and the public on the rationale for separating such costs from program costs, the appropriate level for such costs, and the way these costs support the commission's mission.

#### 6.4. RESOURCES AND REFERENCES

- Cost Accounting Standards Board (CASB), Title 48—*Federal Acquisition Regulations System*, Chapter 99—Cost Accounting Standards Board, Office of Federal Procurement Policy, Office of Management and Budget, Page 406
- *Governmental Accounting, Auditing, and Financial Reporting* (Available through GFOA's online publications catalog)
- GFOA Recommended Practice: "Costing Government Services"
- U.S. Office of Management and Budget (OMB), Circular A-21: *Cost Principles for Educational Institutions*
- U.S. Office of Management and Budget (OMB), Circular A-87: *Cost Principles for State, Local, and Indian Tribal Governments*

**Figure 1: Cost Category Delineation**

<b>ADMINISTRATIVE COST</b> Costs incurred in support of the general management and administration of a First 5 commission, for a common or joint purpose that benefits more than one cost objective (other than evaluation activities), and/or those costs not readily assignable to a specifically benefited cost objective.	<b>PROGRAM COST</b> Costs incurred by local First 5 commissions readily assignable to a program, grantee, contractor, or service provider (other than evaluation activities) and/or in the execution of direct service provision.	<b>EVALUATION COST</b> Costs incurred by local First 5 commissions in the evaluation of funded programs based upon their accountability framework and data collection and evaluation for required reporting to state and local stakeholders.
General accounting/Financial reporting	Direct services	Evaluation*
Local annual reporting activities	Program outreach and education	Evaluation technical assistance
Financial planning	Program planning	Evaluation database
Commission/Association meetings/travel	Program Grants and contracts	
Payroll/Benefits	Program/Provider technical assistance and support (formerly Quality Assurance)	
Human resources services	Program database management	
Legal services/consulting		
Contract compliance		
Audit		
Strategic planning		
Procurement		
Rent		
Maintenance		
Utilities		
Insurance		
Cleaning/Janitorial		
* Includes conduct of focus groups and case studies, state evaluation report production, and presentation.		

## **GLOSSARY**

**accrual basis of accounting:** Transactions are recorded when they occur regardless of when cash is paid or received. Commissions use a modified form of accrual accounting (see Modified Accrual Basis) for Governmental funds. However, the accrual basis of accounting is used for the preparation of annual government-wide financial statements where governmental activities are reported (governmental activities are defined later).

**active investment management:** Active management of an investment portfolio implies that the investing official may sell some securities in order to shift assets into other instruments. This may be done simply to rebalance a portfolio that has become overconcentrated in one sector, or it may reflect an effort to enhance total returns by trading or swapping into securities that are expected to outperform the original holding. Active investment management requires expertise and frequent monitoring of financial markets.

**administrative costs:** Costs incurred for a common or joint purpose that benefits more than one cost objective, supports the general management and administration of a First 5 commission, and/or those costs not readily assignable to a specifically benefited cost objective.

**advance payment:** Any payment made to a contractor before work has been performed or goods have been delivered.

**appropriation:** Appropriations represent the maximum expenditures that are authorized by the governing body of the commission. They represent (by budget category) amounts that cannot be legally exceeded. Internal reporting must provide timely information so the Board of the commission can determine that the spending limits authorized have not been exceeded.

**balance sheet:** The financial statement disclosing the assets, liabilities and equity of the governmental funds (which includes general funds and special revenue funds). Governments are also required to disclose assets, liabilities and equity on a “government-wide entity” basis, using accrual accounting. This is known as the Statement of Net Assets.

**bankers’ acceptance:** A time draft drawn on and accepted by a bank to pay a specified amount of money on a specified date. Bankers’ acceptances are short-term, non-interest bearing notes sold at a discount and redeemed at maturity at face value by the accepting bank. Bankers’ acceptances are backed by the issuers’ guarantee to pay, the underlying goods being financed, and the guarantee of the accepting bank.

**bidder’s conference:** A meeting with potential providers before the proposal submission date.

**broker:** A person or firm that acts as an intermediary by purchasing and selling securities for others rather than for its own account.

**budgetary basis of accounting:** The form of accounting used to describe revenues

and expenditures in the budget document. The term “basis of accounting” is used to describe the timing of recognition, that is, when the effects of transactions or events should be recognized. The basis of accounting used for purposes of financial reporting in accordance with generally accepted accounting principles (GAAP) is not necessarily the same basis used in preparing the budget document. For example, governmental funds are required to use the modified accrual basis of accounting in GAAP financial statements whereas the cash basis of accounting or the “cash plus encumbrances” basis of accounting may be used in those same funds for budgetary purposes. Disparities between GAAP and the budgetary basis of accounting often occur because of regulations that govern budgeting (e.g., laws or ordinances of the state, county, city or some other jurisdiction) which differ from GAAP. There are four basic categories of difference between the budgetary basis of accounting and the basis of accounting that follows generally accepted accounting principles (GAAP) for state and local governments. They are:

- *basis of accounting* – “cash plus encumbrances” and “modified accrual” are two of the different ways to define revenues and expenditures;
- *timing* – the budget period may differ from the accounting reporting period, e.g., lapse periods for encumbrances;
- *perspective* – the budget and accounting reports may have different fund reporting structures, e.g., a budget may account for debt service in the general fund, while GAAP principles require that debt service be recorded in a separate fund;
- *entity* – the government’s financial report may not include all of the same entities and funds as the budget document.

**capital assets:** Land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period. Capital assets historically were also referred to as fixed assets, but that terminology is no longer used in practice.

**cash basis of accounting:** Basis of accounting that recognizes transactions or events when related cash amounts are received or disbursed.

**certificate of deposit:** A time deposit in a financial institution documented by a certificate that bears a specified dollar amount of the deposit, a specified maturity date and a specified interest rate.

**collateral:** Underlying securities that are pledged to secure deposits of public funds. Also used in conjunction with repurchase agreements to protect the entity from default by the counter party.

**collateralization:** The process by which a borrower pledges securities, property, or other deposits for the purpose of securing the repayment of a loan and/or security.

**commercial paper:** An unsecured short-term promissory note issued by corporations, with maturities ranging from 2 to 270 days.

**contract:** A legally binding agreement between two parties for the provision of goods or services.

**county pooled investment funds:** The aggregate of all funds from public agencies placed in the custody of the county treasurer or chief finance officer for investment and reinvestment.

**coupon:** The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value; a certificate attached to a bond evidencing interest due on a payment date.

**credit quality:** The measurement of the financial strength of a bond issuer. This measurement helps an investor to understand an issuer's ability to make timely interest payments and repay the loan principal upon maturity. Generally, the higher the credit quality of a bond issuer, the lower the interest rate paid by the issuer because the risk of default is lower. Credit quality ratings are provided by nationally recognized rating agencies.

**custodian:** A bank or other financial institution that keeps custody of stock certificates and other assets.

**dealer:** Someone who acts as a principal in all transactions, including underwriting, buying, and selling securities, including from his/her own account.

**derivative:** Securities that are based on, or derived from, some underlying asset, reference date, or index.

**disbursements:** The payment of cash for expenditures. Such payments may precede the expenditures (an advance), coincide with the expenditures (a direct payment) or follow the expenditures (the payment of a liability).

**discount securities:** Securities that pay no interest. They are issued at a discount from their face value. An investor's return on investment is the difference between the discounted purchase price and the maturity (or sale) price. U.S. Treasury bills are an example of a discount security.

**encumbrances:** Contractual obligations to make future payments. Encumbrances represent the estimated amount of future expenditures that will result when, for example, purchase orders are placed and contracts are signed. Since the amount of an appropriation cannot be legally exceeded, the placing of purchase orders and the signing of contracts are critical events in controlling the commissions' funds. The financial resources of a fund are said to be encumbered when a transaction is executed that requires performance on the part of another party before the commission becomes liable to perform its part of the transaction (make payment to the entity).

**evaluation costs:** Costs incurred by First 5 commissions in the evaluation of funded programs, in accordance with their accountability framework, and data collection and evaluation for required reporting to state and local stakeholders.

**expenditures:** Take place when a vendor or contractor performs on a contract or a

purchase order, as well as when goods or services are received. An expenditure and a corresponding liability or cash disbursement will be recorded at the time goods or services are received or at the time funds are granted to an authorized recipient.

**fiduciary funds:** Funds used to report assets held in a trustee or agency capacity for others and which therefore cannot be used to support the government's own programs. The fiduciary fund category includes pension (and other employee benefit) trust funds, investment trust funds, private-purpose trust funds, and agency funds.

**fund balance:** The value of the funds available to the commission. Fund balance is the difference between fund assets and fund liabilities of governmental funds.

**GAAP:** Abbreviation for "generally accepted accounting principles," which are conventions, rules, and procedures that serve as the norm for the fair presentation of financial statements. The Governmental Accounting Standards Board (GASB) is responsible for setting GAAP for state and local governments.

**Governmental Accounting Standards Board (GASB):** Ultimate authoritative accounting and financial reporting standard-setting body for state and local governments. The GASB was established in June 1984.

**governmental activities:** Governmental activities are basically all of the governmental funds reported together on an accrual basis. Also, governmental activities include all related capital assets and long-term liabilities and are reported at the government-wide level of reporting.

**governmental funds:** Funds generally used to account for tax-supported activities. There are five different types of governmental funds: the general fund, special revenue funds, debt service funds, capital projects funds, and permanent funds.

**guaranteed investment contracts (GICs):** An agreement acknowledging receipt of funds for deposit, specifying terms for withdrawal, and guaranteeing a rate of interest to be paid.

**interest-only strips:** The interest cash flow portion of a stripped mortgage-backed security or bond. The holder receives no principal payments. A significant loss in value can occur on interest only strips created from mortgage-backed securities when the underlying mortgage prepayments accelerate, typically in a falling interest-rate environment.

**internal control (framework):** Integrated set of policies and procedures designed to assist management to achieve its goals and objectives. To be comprehensive, the framework must: 1) provide a favorable control environment, 2) provide for the continuing assessment of risk, 3) provide for the design, implementation, and maintenance of effective control-related policies and procedures, 4) provide for the effective communication of information, and 5) provide for the ongoing monitoring of the effectiveness of control-related policies and procedures as well as the resolution of potential problems identified by

controls.

**inverse floaters:** A security that reacts inversely to the direction of interest rates. These securities can be very volatile and can lose value in a rising interest-rate environment.

**liquidity:** The ability to convert securities into cash on a short notice. Liquidity incorporates a security holder's ability to sell an instrument without significant loss, as well as other factors that might expedite quick exchange for cash. An example of an illiquid asset would be a nonnegotiable bank certificate of deposit, for which the holder must pay an interest penalty for premature redemption.

**local agency investment fund:** A voluntary investment fund open to government entities and certain non-profit organizations in California that is managed by the State Treasurer's Office.

**local government investment pool (LGIP):** Investment pools that range from the State Treasurer's Office Local Agency Investment Fund (LAIF) to county pools, to Joint Powers Authorities (JPAs). These funds are not subject to the same SEC rules applicable to money market mutual funds.

**long-term financial plan:** A plan that assesses the long-term financial implications of current and proposed policies, programs, and assumptions and develops appropriate strategies to achieve its goals. A financial plan illustrates the likely financial outcomes of particular courses of action or factors affecting the environment in which the government operates. A financial plan is not a forecast of what is certain to happen but rather a device to highlight significant issues or problems that must be addressed if goals are to be achieved.

**market value:** The price at which a security is trading and presumably could be purchased or sold at a particular point in time.

**maturity:** The date on which the principal or stated value of an investment becomes due and payable.

**medium-term note:** Corporate or depository institution debt securities that meets certain minimum quality standards (as specified in the California Government Code) with a remaining maturity of five years or less.

**modified accrual basis of accounting:** The basis of accounting adapted to government fund accounting where revenues are recognized when received in cash or when resources are considered available (except for material or available revenues which should be accrued to reflect properly the taxes levied and the revenues earned – not applicable to county commissions). Expenditures are recognized when the related fund liability is incurred.

**multi-year budgeting:** A multi-year budget is a document that authorizes a government's appropriations (i.e., planned expenditures) and anticipated revenues for two or more consecutive budgetary years. A multi-year budget also may consist of a biennial budget with one or two financial plans that serve as the tentative spending plans for the out-years (i.e., the first year appropriations are formally adopted, whereas the subsequent year "appropriations" are not).

**National Advisory Council on State and Local Budgeting (NACSLB):** A cooperative effort of eight state and local government associations to improve governmental budgeting. To this end, the NACSLB developed a comprehensive set of 59 recommended budgeting practices. These practices address all steps of the budgeting process including: the analysis and goal setting that occurs before the written budget document is produced, the items that should be included in the budget document, and the monitoring and evaluation that occurs after the document is adopted. The recommended practices are available on the Web at <http://www.gfoa.org/services/nacslb/>

**note:** A written promise to pay a specified amount to a certain entity on demand or on a specified date.

**object of expenditure:** In the context of the classification of expenditures, the article purchased or the service obtained, rather than the purpose for which the article or service was purchased or obtained (e.g. personal services, contractual services, materials and supplies).

**outcome:** The end result that is sought. A service may have more than one outcome.

**par:** Face value or principal value of a bond, typically \$1,000 per bond.

**passive investment management:** An investment strategy in which securities are bought with the intention of holding them to maturity or investing in benchmark products designed to yield a market rate of return.

**performance contract:** A type of contract that specifies the end results desired rather than the specific details of how a product should be manufactured or how a service should be delivered.

**performance measure:** A particular value or characteristic designated to measure input, output, outcome, efficiency, or effectiveness.

**portfolio:** Combined holding of more than one stock, bond, commodity, real estate investment, cash equivalent, or other asset. The purpose of a portfolio is to reduce risk by diversification.

**principal:** The face value or par value of a debt instrument, or the amount of capital invested in a given security.

**program costs:** Costs incurred by local First 5 commissions readily assignable to a program, grantee, contractee, or service provider (other than post-contract program evaluation activities) and/or in the execution of direct service provision.

**progress payments:** Partial payments related to steps or phases toward the completion of the required services under a contract.

**progress report:** A report on contract performance or fiscal compliance made at specific intervals during the term of a contract.

**proposal review committee:** A committee or panel that convenes to evaluate the qualifications of bidders who respond to a request for proposals (RFP).

**proprietary funds:** Funds that focus on the determination of operating income, changes in net assets (or cost recovery), financial position, and cash flows. There are two different types of proprietary funds: enterprise funds and internal service funds.

**prudent investor standard:** A statement, often included in laws and investment policies, that specifies the responsibility of government officials in their investment decisions with public funds. The prudent investor standard holds the investor to a higher standard of care than the average prudent person. The prudent investor standard states: “These persons shall act with care, skill, prudence, and diligence under the circumstances then prevailing when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing funds.” The “prudent expert rule” holds an investor to an even higher standard and is often cited in contracts with investment advisors.

**prudent person rule:** A statement, often included in laws and investment policies, that specifies the responsibility of government officials in their investment decisions with public funds. The prudent person rule states: “Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.”

**repurchase agreements:** An agreement of one party (for example, a financial institution) to sell securities to a second party (such as a local agency) and simultaneous agreement by the first party to repurchase the securities at a specified price from the second party on demand or at a specified date.

**request for information (RFI):** The document used to obtain information from potential providers before a solicitation document (RFP) is issued.

**request for proposals (RFP):** The solicitation document that is most appropriate in those situations in which it is necessary and appropriate to evaluate bidders on the basis of their qualifications as well as their price. The RFP describes the qualification requirements, performance specifications, time frames, and other requirements and asks bidders to describe how they would accomplish the services and at what price.

**reserved fund balance:** That portion of a government funds’ balance that is not available for appropriation (i.e., not available for the following period’s budget). Legal restrictions or even third-party entities may impose a limitation on the use of funds or resources that may not be available for spending.

**return on investment:** Investors will face a multitude of securities and other instruments with varying quoted interest rates, coupons, prices, yields and other numbers. The amount of income received from an investment, expressed as a percentage of its price, is the rate of return. A market rate of return is the yield that an investor can expect to receive in the current interest rate environment utilizing a buy-and-hold investment strategy. Total return is interest income plus capital gains

(or minus losses) on an investment and is the most important measure of performance as it is the actual return on investment during a specific time interval. Many investors consider the holding period (from purchase until maturity or sale) the easiest interval to measure the return on investment. Others measure the investment return on a security or portfolio according to various time intervals (monthly, quarterly or annually).

**reverse repurchase agreements:** An agreement of one party (for example, a financial institution) to purchase securities at a specified price from a second party (such as a public agency) and a simultaneous agreement by the first party to resell the securities at a specified price to the second party on demand or at a specified date.

**risk-based monitoring:** An approach to contract monitoring in which reporting requirements are based on a given provider's risk profile.

**Rule G-37 of the Municipal Securities Rulemaking Board:** Federal regulations to sever any connection between the making of political contributions and the awarding of municipal securities business.

**safekeeping:** A procedure where securities are held by a third party acting as custodian for a fee.

**Securities and Exchange Commission (SEC):** The federal agency responsible for supervising and regulating the securities industry.

**securities lending agreement:** An agreement of one party (for example, a local agency) to borrow securities at a specified price from a second party (for example, another local agency) with a simultaneous agreement by the first party to return the security at a specified price to the second party on demand or at a specified date. These agreements generally are collateralized and involve a third-party custodian to hold the securities and collateral. Economically similar to reverse repurchase agreement.

**sole source procurement:** A noncompetitive procurement in which only a single provider is afforded the opportunity to offer a price for desired goods or services.

**secondary market:** The market where securities are sold after their initial issuance.

**stakeholder:** The term "stakeholder" refers to anyone affected by or who has a stake in government. This term includes, but is not limited to: citizens, customers, elected officials, management, employees and their representatives (whether unions or other agents), businesses, other governments, and the media.

**statement of activities:** A government-wide presentation of its activities by function or program using the accrual basis of accounting. The statement presents revenues, expenditures, and a reconciliation of net assets.

**statement of net assets:** The government-wide presentation of assets, liabilities and equity of governmental activities which includes all funds. It is the government-wide balance sheet. The Statement of Net Assets is presented on an accrual basis.

**statement of revenues, expenditures and changes in fund balances:** The governmental fund presentation of the revenues, expenditures and other finance sources and uses of funds. This statement is presented on a modified accrual basis.

**statement of work:** A definition of the services to be delivered and/or the outcomes to be achieved.

**supplantation:** Occurs when new funds are used to fund existing programs. No funds provided by the commission should be used to supplant state or local general fund money for any purpose. In general terms the word supplant means to take the place of, or take the place of something else.

**trustee, trust company or trust department of a bank:** A financial institution with powers to act in a fiduciary capacity for the benefit of the bondholders in enforcing the terms of the bond contract.

**unreserved designated fund balance:** Represents management's intended future use of fund balance (e.g., contingencies, equipment replacement), and generally should reflect actual plans approved by the commissioners.

**unreserved undesignated fund balance:** Represents that portion of the fund balance that has not been allocated for a specific purpose, or have been earmarked in only a general manner where the commission has significant flexibility in changing the amount or nature of the designation.

**U.S. Treasury obligations:** Debt obligations of the U.S. government sold by the Treasury Department in the forms of bills, notes, and bonds. Bills are short-term obligations that mature in one year or less and are sold at a discount. Notes are obligations that mature between one year and ten years. Bonds are long-term obligations that generally mature in 10 years or more.

**weighted average maturity (WAM):** The average maturity of all the securities that comprise a portfolio, typically expressed in days or years.

**yield:** The percentage return on an investment; also called "return." There are several yield calculations that can be made, such as "yield to maturity" and "yield to call." Yield to maturity is the promised return assuming all interest and principal payments are made and reinvested at the same rate taking into account price appreciation (if priced below par) or depreciation (if priced above par). Yield to call is the yield an investor will receive if the security is called prior to maturity.

**yield curve:** A graphic representation that shows the relationship at a given point in time between yields and maturity for bonds that are identical in every way except maturity.

**zero-interest accrual:** Zero interest accrual means the security has the potential to realize zero interest depending upon the structure of the security. Zero coupon bonds and similar investments that start at a level below the face value are legal because their value does increase.